



ORIGINAL

March 29, 1999

Ms. Blanca S. Bayo, Director  
Division of Records & Reporting  
Florida Public Service Commission  
2540 Shumard Oak Blvd.  
Tallahassee, FL 32399-0850

RE: Consummation Report of Securities Issued by Chesapeake  
Utilities Corporation, Docket No. 971397-GU

Dear Ms. Bayo:

Chesapeake Utilities Corporation ("Chesapeake") respectfully files this Consummation Report (original and three copies) on the issuance of securities for the fiscal year ending December 31, 1998 in compliance with Rule 25-8.009, Florida Administrative Code. In satisfaction of the Consummation Report requirements, Chesapeake sets forth the following information:

1. On December 8, 1997, the Florida Public Service Commission ("FPSC") issued Order No. PSC-97-1538-FOF-GU which authorized Chesapeake to issue up to

**ACK** \_\_\_\_\_ 823,296 shares of common stock for the purpose of administering Chesapeake's  
**AFA** 1  
**APP** \_\_\_\_\_ Retirement Savings Plan, Performance Incentive Plan, Automatic Dividend Reinvestment  
**CAF** \_\_\_\_\_ and Stock Purchase Plan, and the conversion of Chesapeake's convertible debentures.  
**CMU** \_\_\_\_\_  
**CTR** \_\_\_\_\_ The Order also authorized Chesapeake to issue up to 4,176,704 shares of common stock  
**EAG** \_\_\_\_\_  
**LEG** 1 and \$40 million in secured and/or unsecured debt for the purpose of financing  
**LIN** \_\_\_\_\_ Chesapeake's acquisition program. In addition, the Order authorized Chesapeake to issue  
**OPC** \_\_\_\_\_  
**RCH** \_\_\_\_\_ up to \$30 million in secured and/or unsecured debt to be used for general corporate  
**SEC** 1  
**WAS** \_\_\_\_\_  
**OTH** \_\_\_\_\_

DOCUMENT NUMBER-DATE

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Chesapeake Utilities Corporation

909 Silver Lake Boulevard

Dover, Delaware 19904

302.734.6799

302.734.6750 / fax  
DIVISION OF RECORDS & REPORTING

purposes, including, but not limited to, working capital, retirement of short-term debt, retirement of long-term debt and capital improvements.

2. Of the above-mentioned securities, and for the twelve-month period ending December 31, 1998, Chesapeake has issued the following:

- (a) 26,018 shares of common stock were issued for the purpose of administering Chesapeake's Retirement Savings Plan. The average issuance price of these shares was \$17.94 per share. Expenses associated with this issuance were negligible.
- (b) 24,366 shares of common stock were issued for the Performance Incentive Plan. The average issuance price of these shares was \$19.25 per share. Expenses associated with this issuance were negligible.
- (c) 32,925 shares of common stock were issued for the purpose of administering Chesapeake's Automatic Dividend Reinvestment and Stock Purchase Plan. The average issuance price of these shares was \$18.53 per share. Expenses associated with this issuance were negligible.
- (d) 6,401 shares of common stock were issued for the conversion of debentures. The average issuance price of these shares was \$17.01 per share. Expenses associated with this issuance were negligible.
- (e) 25,000 shares of Chesapeake stock were issued on March 31, 1998 in exchange for all of the outstanding common stock of Sam Shannahan Well Co., Inc. dba Tolan Water Service ("SSWC"). Subject to the terms and conditions set forth in the Agreement and Plan of Merger (the "Merger

Agreement”), Chesapeake issued 25,000 shares of its stock to the shareholders of SSWC. The shares of Chesapeake common stock issued pursuant to the Merger Agreement were issued as restricted securities, pursuant to Rule 144 under the Securities Act of 1933 and subject to certain registration rights. These rights provided that Chesapeake would include the 25,000 shares issued pursuant to the Merger Agreement in any registration statement that it filed within twelve (12) months from March 31, 1998.

- (f) 475,000 shares of Chesapeake stock were issued on May 29, 1998 in exchange for all of the outstanding common stock of Xeron, Inc. (“Xeron”). Subject to the terms and conditions set forth in the Agreement and Plan of Merger (the “Agreement of Merger”), Chesapeake issued 475,000 shares of its stock to the shareholders of Xeron. The shares of Chesapeake common stock issued pursuant to the Agreement of Merger were issued as restricted securities pursuant to Rule 144 under the Securities Act of 1933 and subject to certain registration rights. The Registration Rights Agreements, which set forth the terms and conditions of these registration rights, were executed by the Xeron shareholders, individually, also on May 29, 1998. Pursuant to the terms and conditions of the Registration Rights Agreements, Chesapeake filed a Registration Statement (Form S-3) with the Securities and Exchange Commission on September 30, 1998. Included in this Registration

Statement were also the SSWC shares. Total expenses associated with this issuance are estimated to be \$15,704.

3. Schedules showing capitalization, pretax interest coverage and debt interest requirements as of December 31, 1997 are attached hereto as Exhibit A.

4. A copy of the Merger Agreement with SSWC is attached hereto as Exhibit B. A copy of the application to the Delaware Public Service Commission requesting authority to issue the 25,000 shares is attached hereto as Exhibit C. A copy of the Order of the Delaware Public Service Commission authorizing the issuance of the 25,000 shares is attached hereto as Exhibit D.

5. A copy of the Agreement of Merger with Xeron is attached hereto as Exhibit E. Copies of the Registration Rights Agreements are attached hereto as Exhibit F. A copy of the registration statement/Form S-3 is attached hereto as Exhibit G. A copy of the application to the Delaware Public Service Commission requesting authority to issue the 475,000 shares is attached hereto as Exhibit H. A copy of the Order of the Delaware Public Service Commission authorizing the issuance of the 475,000 shares is attached hereto as Exhibit I.

6. Except for those agreements provided as Exhibits to this document, copies of all Plans, Agreements, registration filings with the Securities and Exchange Commission and Orders of the Delaware Public Service Commission authorizing the issuance of the above securities have been previously filed with the FPSC under Docket Nos. 931112-GU and 941212-GU and are hereby incorporated by reference.



7. Copies of the signed Opinions of Counsel with respect to the legality of the 25,000 shares are attached hereto under Exhibit J.

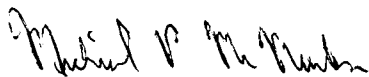
8. A copy of the signed Opinion of Counsel with respect to the legality of the 475,000 shares is attached hereto under Exhibit K.

9. Signed copies of the Opinions of Counsel with respect to the legality of all other securities issued have been previously filed with the FPSC as exhibits to the Consummation Reports of Securities Issued by Chesapeake Utilities Corporation, Docket Nos. 931112-GU and 941212-GU, dated April 1, 1994 and January 2, 1996, respectively, and are hereby incorporated by reference.

10. A copy of Chesapeake's most current Form 10-K as filed with the Securities and Exchange Commission is attached hereto as Exhibit L.

We respectfully submit this Consummation Report on the issuance of securities by Chesapeake Utilities Corporation, Florida Public Service Commission Docket No. 971397-GU, this 29th day of March, 1999.

Sincerely,

A handwritten signature in dark ink, appearing to read "Michael P. McMasters", written in a cursive style.

Michael P. McMasters

Vice President, Treasurer and CFO

CHESAPEAKE UTILITIES CORPORATION  
Opinions of Counsel

The legality of the issuance of securities is addressed in the attached Opinions of Counsel as follows:

<u>Securities Issued</u>	<u>Applicable Opinions</u>
25,000 shares issued for the SSWC merger	Schmittinger & Rodriguez, P.A. March 2, 1998 Laws & Laws, P.A. March 31, 1998
475,000 shares issued for the Xeron merger	Schmittinger & Rodriguez, P.A. April 29, 1998

CHESAPEAKE UTILITIES CORPORATION  
Summary of Exhibits

<u>Exhibit Reference</u>	<u>Description</u>
Exhibit A	Schedules showing capitalization, pretax interest coverage and debt requirements as of December 31, 1997
Exhibit B	Merger Agreement with SSWC
Exhibit C	Delaware Public Service Commission Application for the 25,000 shares
Exhibit D	Delaware Public Service Commission Order authorizing the issuance of the 25,000 shares
Exhibit E	Agreement of Merger with Xeron
Exhibit F	Registration Rights Agreement executed with the Xeron shareholders
Exhibit G	Registration Statement/Form S-3
Exhibit H	Delaware Public Service Commission Application for the 475,000 shares
Exhibit I	Delaware Public Service Commission Order authorizing the issuance of the 475,000 shares
Exhibit J	Opinions of Counsel regarding the legality of the 25,000 shares being issued in exchange for the SSWC stock
Exhibit K	Opinion of Counsel regarding the legality of the 475,000 shares being issued in exchange for the Xeron stock
Exhibit L	December 31, 1997 Form 10-K

CHESAPEAKE UTILITIES CORPORATION  
Capitalization Ratios Actual & Pro Forma as of December 31, 1997

UNAUDITED

	ACTUAL BEFORE ISSUANCE			PRO FORMA AFTER ISSUANCE	
TYPE OF CAPITAL	AMOUNT OUTSTANDING	% OF TOTAL	PRO FORMA ADJUSTMENT	AMOUNT OUTSTANDING	% OF TOTAL
COMMON EQUITY					
COMMON STOCK	\$2,191,792	2.27%	\$287,227	\$2,479,019	2.47%
PAID IN CAPITAL	19,819,604	20.49%	4,372,584	24,192,188	24.14%
RETAINED EARNINGS	<u>28,324,749</u>	<u>29.28%</u>	0	<u>28,324,749</u>	<u>28.26%</u>
TOTAL COMMON EQUITY	<u>50,336,145</u>	<u>52.04%</u>	<u>4,659,811</u>	<u>54,995,956</u>	<u>54.87%</u>
PREFERRED STOCK	0	0.00%	0	0	0.00%
LONG-TERM DEBT					
FIRST MORTGAGE BONDS	4,300,000	4.44%	0	4,300,000	4.29%
CONVERTIBLE DEBENTURES	3,926,000	4.06%	0	3,926,000	3.92%
SENIOR NOTES	30,000,000	31.01%	0	30,000,000	29.93%
OTHER	0	0.00%	0	0	0.00%
TOTAL LONG-TERM DEBT	<u>38,226,000</u>	<u>39.51%</u>	0	<u>38,226,000</u>	<u>38.14%</u>
TOTAL PERMANENT CAPITAL	<u>88,562,145</u>	<u>91.55%</u>	<u>4,659,811</u>	<u>93,221,956</u>	<u>93.01%</u>
CURRENT PORTION OF LTD	582,500	0.60%	472,200	1,054,700	1.05%
SHORT-TERM DEBT	<u>7,600,000</u>	<u>7.85%</u>	<u>(1,654,602)</u>	<u>5,945,398</u>	<u>5.94%</u>
TOTAL CAPITALIZATION	<u>\$96,744,645</u>	<u>100.00%</u>	<u>\$3,477,409</u>	<u>\$100,222,054</u>	<u>100.00%</u>

CHESAPEAKE UTILITIES CORPORATION  
Statement of Income and Pretax Interest Coverage  
Actual & Pro Forma for the Twelve Months Ended December 31, 1997

UNAUDITED

	<u>Annualized Twelve Months</u>		
	Actual Before <u>Issuance</u>	Pro Forma Adjustment	Pro Forma After <u>Issuance</u>
<u>Statement of Income</u>			
1 Operating revenues	\$75,959,937	\$0	\$75,959,937
2 Operating expenses before income taxes	70,461,466	15,704	70,477,170
3 Income taxes (Including Deferrals)	1,345,141	(6,282)	1,338,859
4 Operating Income (1-(2+3))	4,153,330	(9,422)	4,143,908
5 Other Income, Net	47,807	0	47,807
6 Income Before Interest Charges (4+5)	4,201,137	(9,422)	4,191,715
7 Interest Charges	1,974,153	0	1,974,153
8 Net Income (6-7)	2,226,984	(9,422)	2,217,562
9 Preferred stock dividends	0	0	0
10 Earnings available to common equity (8-9)	\$2,226,984	(\$9,422)	\$2,217,562
11 Pretax Interest Coverage ((3+6)/7)	2.81	N/A	2.80

CHESAPEAKE UTILITIES CORPORATION

Notes to Capitalization, Income and  
Pretax Interest Coverage Schedules  
As of December 31, 1997

The following adjustments have been made to capitalization:

Common Stock - Number of shares (589,710) times par value (\$0.4867 per share), with the shares issued for the following purposes:

- 26,018 shares for the Retirement Savings Plan
- 24,366 shares for the Performance Incentive Plan
- 32,925 shares for the Automatic Dividend Reinvestment and Stock Purchase Plan
- 6,401 shares for the conversion of debentures
- 25,000 shares for the SSWC merger
- 475,000 shares for the Xeron merger

Additional Paid in Capital - Total cash value less the associated Common Stock amount for the following issuances:

- 26,018 shares at \$17.94 per share
- 24,366 shares at \$19.25 per share
- 32,925 shares at \$18.53 per share
- 6,401 shares at \$17.01 per share
- 25,000 shares recorded at \$63,535 for the SSWC merger due to a reclass between Common Stock and Additional Paid in Capital
- 475,000 shares recorded at \$2,697,703 for the Xeron merger due to a reclass between Common Stock and Additional Paid in Capital

Current Portion of Long-Term Debt -

With the SSWC merger, Chesapeake assumed \$472,200 of debt, which is shown as current portion of long-term debt because it was paid off by Chesapeake at closing.

Short-Term Debt -

Decrease by a total of \$1,654,602 to reflect the pay down of short-term lines of credit with proceeds from the Retirement Savings Plan, Performance Incentive Plan, Automatic Dividend Reinvestment and Stock Purchase Plan and the conversion of certain debentures.

CHESAPEAKE UTILITIES CORPORATION

Notes to Capitalization, Income and  
Pretax Interest Coverage Schedules (continued)  
As of December 31, 1997

The following adjustments have been made to the Statement of Income and Pretax Interest Coverage Schedule:

1. Operating Expenses - Represents the issuance costs for the stock exchanged by Chesapeake in the SSWC and Xeron mergers.
2. Income Taxes - Taxes associated with above increase in Operating Expenses, assuming a tax rate of 40%.

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7. Employment and Non-Competition Agreement
8. Opinion of Chesapeake's Counsel
9. Opinion of SSWC's/Shannahan's Counsel
10. Investment Letter

## AGREEMENT AND PLAN OF MERGER

THIS AGREEMENT AND PLAN OF MERGER (the "Agreement") is made and entered into this 20<sup>th</sup> day of March, 1998, by and among Chesapeake Utilities Corporation, a Delaware corporation ("Chesapeake"), CPK Sub-B, Inc., a Delaware corporation ("CPK Sub-B"), Sam Shannahan Well Co., Inc., d/b/a Tolan Water Service, a Maryland corporation ("SSWC"), and Dashiell J. (Duke) Shannahan, and Joyce C. Shannahan, residents of Maryland (each, a "Shareholder" and collectively, the "Shareholders").

### ARTICLE I THE MERGER

SECTION 1.1 The Merger. Upon the terms and subject to the conditions hereof, as promptly as practicable following the satisfaction or waiver of the conditions set forth in Article VIII hereof, but in no event later than two business days thereafter, unless the parties hereto shall otherwise agree, articles of merger (the "Articles of Merger") providing for the merger of CPK Sub-B with and into SSWC (the "Merger") shall be duly prepared, executed and filed by SSWC, as the surviving corporation (the "Surviving Corporation"), in accordance with the relevant provisions of the Maryland General Corporation Law (the "MGCL") and the Merger shall become effective. Following the Merger, the Surviving Corporation shall continue under the same name as SSWC and the separate corporate existence of CPK Sub-B shall cease. The date and time the Merger becomes effective is referred to herein as the "Effective Time." Immediately prior to the filing of the Articles of Merger, a closing (the "Closing") shall take place at the offices of Laws & Laws, P.A., 209 East Main Street, Salisbury, Maryland 21801, or such other place and time as the parties shall agree.

SECTION 1.2 Effects of the Merger. The Merger shall have the effects set forth in Section 3-114 of the MGCL.

SECTION 1.3 Articles of Incorporation and By-Laws. The Articles of Incorporation of SSWC and the By-laws of CPK Sub-B (both of which have been heretofore delivered by SSWC to Chesapeake or Chesapeake to SSWC, as the case may be), in each case as in effect immediately prior to the Effective Time, shall be the Articles of Incorporation and By-laws of the Surviving Corporation until duly amended in accordance with applicable law.

SECTION 1.4 Directors. The directors of CPK Sub-B immediately prior to the Effective Time shall be the initial directors of the Surviving Corporation and shall hold office until their respective successors are duly elected and qualified in accordance with the Articles of Incorporation and By-laws of the Surviving Corporation, or their earlier death, resignation or removal.

SECTION 1.5 Officers. The officers of CPK Sub-B immediately prior to the Effective Time shall be the initial officers of the Surviving Corporation and shall serve as the officers of the Surviving Corporation at the pleasure of the Board of Directors of the Surviving Corporation.

SECTION 1.6 Conversion of Shares. At the Effective Time, by virtue of the Merger and without any action on the part of the holders thereof:

(a) Subject to Section 2.2, each issued and outstanding shares of common stock, par value \$10.00 per share, of SSWC (the "SSWC Common Stock") shall automatically be converted into the right to receive (the "Merger Consideration") that amount of fully paid and nonassessable shares of common stock, par value \$.4867 per share, of Chesapeake (the "Chesapeake Common Stock"), which shall be determined by dividing 25,000 by the aggregate number of outstanding shares of SSWC Common Stock at the Effective Time (the "Exchange Ratio"), provided that in the event of a stock split or reverse stock split in either the SSWC Common Stock or the Chesapeake Common Stock prior to the Effective Time, the Exchange Ratio shall be adjusted proportionately in order to prevent either dilution or enlargement of the rights of the Shareholders.

(b) Each share of capital stock of SSWC that is held in the treasury of SSWC shall be canceled and retired and cease to exist and no consideration shall be issued in exchange therefor.

(c) The issued and outstanding shares of capital stock of CPK Sub-B shall be converted into and become, in the aggregate, 1000 fully paid and nonassessable shares of common stock of the Surviving Corporation.

## ARTICLE II EXCHANGE OF SHARES

SECTION 2.1 Surrender of Certificates. At the Closing, each of the Shareholders shall surrender the certificate or certificates that formerly represented that Seller's shares of SSWC Common Stock to the Surviving Corporation, and shall thereupon receive in exchange therefor the Merger Consideration for each share of SSWC Common Stock formerly represented by such certificate or certificates, and the certificates so surrendered shall forthwith be cancelled. At the Closing, certificates for the number of Chesapeake Common Stock equivalent to the Merger Consideration shall be delivered to Shareholders.

SECTION 2.2 No Fractional Shares. No certificate or scrip representing fractional shares of Chesapeake Common Stock shall be issued upon the surrender for exchange of certificates of SSWC Common Stock, and such fractional share interests will not entitle the owner thereof to vote or to any rights of a stockholder of Chesapeake. In lieu of any such fractional share interest, Chesapeake shall issue to Shareholders jointly, as tenants by the entireties, any share which would otherwise be required or be divided

into fractional shares by applying the Exchange Ratio to the Shareholders' separate respective shares of the SSWC Common Stock as provided in Section 1.6(a) of this Agreement.

ARTICLE III  
REPRESENTATIONS AND WARRANTIES  
OF SSWC AND SHAREHOLDERS

SSWC and each of the Shareholders, severally and not jointly, represents and warrants to Chesapeake and CPK Sub-B as follows:

SECTION 3.1 Corporate Organization.

(a) SSWC is a corporation duly organized, validly existing and in good standing under the laws of Maryland and has all requisite corporate power and authority to own, lease and operate its properties and to carry on its business as now being conducted. SSWC is currently qualified and properly licensed to do business in and is in good standing in Maryland. SSWC has heretofore delivered to Chesapeake accurate and complete copies of its Articles of Incorporation and By-laws, as in effect on the date of this Agreement.

(b) SSWC does not own, directly or indirectly, any capital stock or other equity securities or similar interest in any corporation, partnership, joint venture, or other business association or entity.

(c) Since at least December 31, 1995, SSWC has never been a subsidiary of another organization or had any other corporation, partnership, joint venture, or other business association or entity own or hold any of its capital stock, equity securities or similar interest.

SECTION 3.2 Capitalization.

(a) The authorized capital stock of SSWC consists of 10,000 shares of SSWC Common Stock, of which 5100 shares are issued and outstanding. Shareholder Dashiell J. Shannahan owns 2,600 shares and Shareholder Joyce C. Shannahan owns 2,500 shares. All of the issued and outstanding shares of SSWC Common Stock are validly issued, fully paid and nonassessable. As of the date of this Agreement, no shares of SSWC Common Stock were issuable upon exercise of stock options or warrants or conversion of any preferred stock or debt security or instrument. There are not as of the date of this Agreement, and at the Effective Time there will not be, any shares of capital stock (or securities substantially equivalent to capital stock) of SSWC issued or outstanding or any subscriptions, options, warrants, calls, rights, convertible securities or other agreements or commitments of any character obligating SSWC to issue, transfer or sell any of its securities or outstanding shares of SSWC Common Stock.

(b) There has been no change in the equity ownership of SSWC, since, at the latest, December 31, 1995.

SECTION 3.3 Authority Relative to this Agreement; Binding Effect.

(a) SSWC has full corporate power and authority to execute and deliver this Agreement and to consummate the transactions contemplated hereby. The execution and delivery of this Agreement and the consummation of the transactions contemplated hereby have been duly and validly authorized and approved by the Board of Directors of SSWC and by the unanimous vote or written consent of the stockholders of SSWC and no other corporate proceedings on the part of SSWC are necessary to authorize this Agreement or to consummate the transactions so contemplated. This Agreement has been duly and validly executed and delivered by SSWC and constitutes a legal, valid and binding agreement of SSWC, enforceable against SSWC in accordance with its terms.

(b) This Agreement has been duly and validly executed and delivered by each Shareholder and constitutes a legal, valid and binding agreement of each Shareholder, enforceable against each Shareholder in accordance with its terms.

SECTION 3.4 Consents and Approvals. Except for the filing and recordation of the Articles of Merger, as required by the MGCL, no filing with or notification to, and no permit, authorization, consent, waiver or approval of, any government, executive official thereof, governmental or regulatory authority, agency or commission, including courts of competent jurisdiction, domestic or foreign (a "Governmental Entity"), is necessary for the consummation by SSWC and the Shareholders of the transactions contemplated by this Agreement, excluding, however, filings, permits, authorizations, consents, or approvals of any kind required due to Chesapeake's or CPK Sub-B, Inc.'s role in this transaction.

SECTION 3.5 Absence of Certain Changes. Since November 30, 1997 SSWC has not:

(a) suffered any material adverse change ("SSWC Material Adverse Change"). As used herein, SSWC Material Adverse Change means (i) any material change in the nature of SSWC, business, assets, financial condition, results of operations, or prospects, (ii) the loss of a contract which contributed in excess of twenty thousand dollars (\$20,000.00) of revenues to SSWC in fiscal year 1997, and (iii) any change that creates a material limitation on the ability to conduct the business of SSWC as heretofore conducted;

(b) paid, discharged or otherwise satisfied any material claims, liabilities or obligations (absolute, accrued, contingent or otherwise) other than the payment, discharge or satisfaction in the ordinary course of business and consistent with past practice;

(c) permitted or allowed any of its material property or assets (real, or mixed, tangible or intangible) to be subjected to any Liens, except for: (i) Liens for current taxes

or other governmental charges not yet due and payable, or the validity of which is being contested by appropriate proceedings and for which an appropriate reserve has been established; (ii) Liens of carriers, warehousemen, mechanics and materialmen and similar Liens incurred in the ordinary course of business; and (iii) zoning and other land use regulations (collectively, "Permitted Liens");

(d) sold, transferred, or otherwise disposed of any of its properties or assets (real, personal or mixed, tangible or intangible), except in the ordinary course of business and consistent with past practice;

(e) granted any increase in the compensation or benefits of any officer or employee (including any such increase pursuant to any bonus, pension, profit sharing or other plan or commitment) or any increase in the compensation or benefits payable or to become payable to any officer or employee, and no such increase is customary on a periodic basis or required by agreement or understanding;

(f) made any change in severance policy or practices;

(g) made any expenditure capitalized in accordance with SSWC's current accounting policies or acquired any property or assets (other than new materials and supplies) for a cost in excess of \$20,000, in the aggregate, excluding from this aggregate amount expenditures in the ordinary course of business on water treatment supplies and equipment and new vehicles, the purchase of which has been previously disclosed to Chesapeake;

(h) declared, paid or set aside for payment any dividend or other distribution in respect of its capital stock or redeemed, purchased or otherwise acquired, directly or indirectly, any shares of capital stock or other securities of SSWC;

(i) made any material change in any method of tax or financial accounting or accounting practice or made or changed any election for Federal income tax purposes without the consent of Chesapeake;

(j) paid (other than usual and reasonable compensation), loaned or advanced any amount to, or sold, transferred or leased any properties or assets (real, personal or mixed, tangible or intangible) to, or entered into any agreement or arrangement with, any of its officers, directors or stockholders or any affiliate or associate of any of its officers, directors or stockholder, except as disclosed to Chesapeake; or

(k) agreed or planned, whether in writing or otherwise, to take any action described in this Section.

**SECTION 3.6 Unaudited Financial Statements.** SSWC shall have furnished to Chesapeake prior to the date of this Agreement an unaudited balance sheet of SSWC as of February 28, 1998 and an unaudited statement of operations for the six month period



ending February 28, 1998, (collectively, the "Unaudited Financial Statements"). The Unaudited Financial Statements are attached to this Agreement and made a part hereof as Exhibit 1. Such Unaudited Financial Statements shall be certified by the Chief Executive Officer of SSWC as having been prepared under his supervision; to be true, correct and complete in all material respects; and to reflect accurately the books and records of SSWC, in all material respects, subject to normal year-end adjustments.

SECTION 3.7 No Undisclosed Liabilities. Except as and to the extent provided in the Unaudited Financial Statements, since February 28, 1998, SSWC has not incurred any material (i.e., over \$10,000) liability except in the ordinary course of business consistent with past practice.

SECTION 3.8 No Default; No Violations.

(a) SSWC is not in default or violation (and no event has occurred that with notice or the lapse of time or both would constitute a default or violation) of any term, condition or provision of (i) its Articles of Incorporation or its By-laws, (ii) any note, bond, mortgage, indenture, license, contract, agreement or other instrument or obligation to which SSWC is a party or by which it or any of its properties or assets may be bound (unless, in the case of a contract, such default would not have a material adverse effect on SSWC), or (iii) any order, written injunction, decree, statute, rule or regulation applicable to SSWC or any of its properties or assets, unless such default or violation will not have a material adverse effect on SSWC.

(b) Neither the execution and delivery of this Agreement by SSWC and the Shareholders nor the consummation by SSWC and the Shareholders of the transactions contemplated hereby nor compliance by SSWC and the Shareholders with any of the provisions hereof will (i) conflict with or result in any breach of any provision of the Articles of Incorporation or By-laws of SSWC, (ii) result in a violation or breach of, or constitute (with or without due notice or lapse of time or both) a default (or give rise to any right of termination, cancellation or acceleration or result in the creation of any mortgage, pledge, charge, security interest, claim or encumbrance of any kind (collectively, a "Lien") under, any of the terms conditions or provisions of any note, bond, mortgage, indenture, license, contract, agreement or other instrument or obligation to which SSWC or a Shareholder is a party or by which they or any of their properties or assets may be bound, or (iii) violate any order, writ, injunction, decree, or statute applicable to SSWC or a Shareholder or any of their properties or assets, or (iv) result in a violation of any rule or regulation applicable to SSWC or a Shareholder or any of their properties or assets.

SECTION 3.9 Litigation. To the best of SSWC's and the Shareholders' knowledge (which, at a minimum includes any notices served on or any calls to or personal contact made with SSWC's officers or either Shareholder), there is no action, suit, proceeding, arbitration, or investigation pending or threatened by or before any Governmental Entity or arbitrator involving SSWC or any of its properties or assets.

Neither SSWC nor any of its properties or assets is subject to any order, writ, judgment, injunction, decree, determination or award. There is no action, suit, proceeding, arbitration or investigation initiated by SSWC currently pending or that SSWC presently intends to initiate.

#### SECTION 3.10 Compliance with Applicable Law.

(a) The business of SSWC has not been conducted in knowing violation of any applicable law, ordinance, rule, regulation, decree or order of any Governmental Entity. SSWC holds all permits, licenses, variances, exemptions, orders and approvals of all Governmental Entities necessary for the lawful conduct of its businesses (the "SSWC Permits") and is in compliance with the terms of the SSWC Permits. Neither SSWC nor either Shareholder has received any notification of any asserted present or past failure by SSWC to comply with such laws, rules or regulations or such SSWC Permits, or any such asserted failures have been previously cured, and to the knowledge of SSWC, there is no pending audit, investigation or other review by any Governmental Entity to determine the existence of any violation of such laws, rules or regulations or such SSWC Permits.

(b) For purposes of this Agreement, "knowledge of SSWC" or "known by SSWC" shall include knowledge of either SSWC or either of the Shareholders.

#### SECTION 3.11 Taxes.

(a) From the date of its inception, SSWC has been a C corporation as defined by the Internal Revenue Code of 1986, as amended, and the rules and regulations promulgated thereunder (the "Code").

(b) The amounts, if any, provided as a liability on the Unaudited Financial Statements for all Taxes (as hereinafter defined) are adequate to cover substantially all unpaid liabilities for all Taxes, whether or not disputed, that have accrued or will accrue with respect to, or which are applicable to, SSWC for the period ended on and including the Effective Time (including, without limitation, as a result of the transactions contemplated by this Agreement) or to any years and periods prior thereto and for which SSWC may be directly or contingently liable in its own right or as a transferee of the assets of, or successor to, any person. SSWC has incurred no Tax liabilities other than in the ordinary course of business for any taxable year for which the applicable statute of limitations has not expired. There are no liens for Taxes (other than Liens for current Taxes not yet due and payable, or the amount or validity of which is being contested by the appropriate proceedings and for which an appropriate reserve has been established) upon the properties or assets of SSWC or of any Shareholder. SSWC has not granted or been requested to grant any waiver of any statutes of limitations applicable to any claim for Taxes. Since the date in Section 3.11(a) above, apart from normal elections for inventory, amortization, and depreciation, SSWC has made no material elections for federal income tax purposes.

(c) SSWC (i) has filed (or has had filed on its behalf) or will file or cause to be filed timely all Tax Returns (as hereinafter defined) required by applicable law to be filed prior to or as of the Effective Time and (ii) has paid all Taxes shown thereon as owing. Each such Tax Return is true, accurate and complete. All Taxes that SSWC is required by law to withhold or collect, including sales and use taxes, and amounts required to be withheld for Taxes of employees and other withholding taxes, have been duly withheld or collected and, to the extent required, have been paid in a timely manner to the proper governmental authorities or are held in separate bank accounts for such purpose.

(d) No extensions of time have been granted for SSWC to file any Tax Return required by applicable law to be filed prior to or as of the Effective Time, which have expired, or will expire, prior to or as of the Effective Time without such Tax Return having been filed.

(e) To the best of the knowledge of the Shareholders, or as should be reasonably known by SSWC: (i) none of the Tax Returns filed by or on behalf of SSWC are currently undergoing any Audit (as hereinafter defined), SSWC has received no notice that any Tax Return will undergo any Audit, and no facts exist that would constitute grounds for the assessment against SSWC of any material additional Taxes by any governmental authority for periods that have not been audited; (ii) no material issues have been raised in any Audit by any governmental authority with respect to the business and operations of SSWC that, by application of similar principles, reasonably could be expected to result in a proposed adjustment to the liability for Taxes for any other period not so examined; and (iii) no deficiency or adjustment for any Taxes has been threatened, proposed, asserted, or assessed against SSWC.

(f) No power of attorney has been granted by SSWC with respect to any matter relating to Taxes which is currently in force.

(g) SSWC is not a party to any agreement providing for the allocation or sharing of Taxes.

(h) SSWC has not entered into any agreement that would result in the disallowance of any tax deduction pursuant to Code Section 280G (relating to "golden parachutes").

(i) No "consent" within the meaning of Code Section 341(f) has been filed with respect to SSWC (relating to "collapsible corporations").

(j) None of the assets of SSWC constitutes tax-exempt bond financed property or tax-exempt use property within the meaning of Code Section 168, and none of the assets reflected on the Unaudited Financial Statements is subject to a lease, safe harbor lease or other arrangement as a result of which SSWC is not treated as the owner of such assets for federal income tax purposes.

(k) To the best of the knowledge of or as reasonably should be known by SSWC, the basis of all depreciable or amortizable assets, and the methods used in determining allowable depreciation or amortization (including cost recovery) deductions of SSWC, are materially correct and in compliance with the Code.

(l) To the best of the knowledge of SSWC, SSWC is not required to make any material adjustment under Code Section 481(a) by reason of a change or proposed change in accounting method or otherwise.

(m) For purposes of this Agreement:

(i) the term "Taxes" shall mean all taxes, charges, fees, duties (including customs duties), levies or other assessments, including income, gross receipts, net proceeds, ad valorem, turnover, real and personal property (tangible and intangible), sales, use, franchise, excise, value added, stamp, leasing, lease, user, transfer, fuel, excess profits, occupational, interest equalization, windfall profits, severance, license, payroll, environmental, capital stock, disability, employee's income withholding, other withholding, unemployment and Social Security taxes, which are imposed by any federal, state or local governmental authority, and such term shall include any interest, penalties or additions to tax attributable thereto;

(ii) the term "Tax Return" shall mean all federal, state and local tax returns, declarations, statements, reports, schedules, forms and information returns and any amended Tax Return relating to Taxes; and

(iii) the term "Audit" shall mean any governmental taxing authority's audit, assessment of Taxes or other examination proceedings or appeal of such proceedings relating to Taxes.

#### SECTION 3.12 ERISA.

(a) Except as and to the extent described in subparagraph (g) hereof, SSWC does not maintain or contribute to any "employee benefit plan," as such term is defined in the Employee Retirement Income Security Act of 1974, as amended, and the rules and regulations promulgated thereunder ("ERISA"). The employee benefits plans disclosed in subparagraph (g) hereof are referred to as the "ERISA Plans." With respect to any ERISA Plan, SSWC has provided Chesapeake with a true and complete copy of each of the following: (i) the current plan document (including all amendments) and the most recent summary plan description; (ii) the annual report on Form 5500 for the most recent year for which such report has been filed; (iii) each related trust agreement, insurance contract or investment management agreement; and (iv) the most recent Internal Revenue Service ("IRS") determination letter. Any obligation of SSWC to provide postretirement benefits or postemployment benefits under any ERISA Plan is reflected in SSWC's Unaudited Financial Statements.

(b) SSWC has complied in all material respects with all applicable provisions of ERISA and the Code and with any other laws, rules, and regulations that are applicable to the ERISA Plans, except for compliance failures that individually or in the aggregate would not have a material adverse effect on SSWC.

(c) SSWC has not offered to provide health insurance coverage to any individual, or to the family members of any individual, for any period extending beyond the termination of the individual's employment, except to the extent required by the health care continuation coverage ("COBRA") provisions in ERISA and the Code. SSWC will supply to Chesapeake a complete list of any present COBRA participants.

(d) SSWC has not at any time during the ten calendar years preceding the year of the merger hereby contemplated maintained, or contributed to, any defined benefit plan covered by Title IV of ERISA or incurred any liability under Title IV of ERISA, and the transactions contemplated by this Agreement will not subject SSWC to any liability under Title IV of ERISA.

(e) There are no pending or, to the best of the knowledge of SSWC, threatened claims (other than routine claims for benefits) by or on behalf of any ERISA Plan, or otherwise involving any ERISA Plan, by any participant, beneficiary, or fiduciary under such ERISA Plan.

(f) Each ERISA Plan and any other employee benefit plan maintained by SSWC can be terminated within a period of 30 days, without payment of additional compensation or amount or the additional vesting or acceleration of any benefits.

(g) Employee benefit plans, including but not limited to ERISA plans, that are maintained by SSWC as of the Effective Date, are set forth below: Simplified Employee Pension ("SEP") plan, as disclosed on Exhibit 3.

### SECTION 3.13 Environmental Matters.

(a) Neither SSWC nor either Shareholder has learned of, been advised of, or received any communication (written or oral), whether from a governmental authority, citizens group, employee or otherwise, that alleges or suggests that SSWC or either Shareholder is not in full compliance with the Environmental Laws with respect to the Real Property (as defined herein) or the operations of SSWC.

(b) To the best of the knowledge of SSWC and each Shareholder, there are no Environmental Claims (as hereinafter defined) pending or threatened against SSWC or either Shareholder or against any person or entity whose liability for any Environmental Claim SSWC or either Shareholder has assumed, either contractually or by operation of law, and neither SSWC nor either Shareholder knows of any facts or allegations that could result in future Environmental Claims with respect to the Real Property (as defined herein) or the operations of SSWC.

(c) To the best of the knowledge of SSWC and each Shareholder, none of the Real Property, (as defined herein), nor any other property leased by SSWC, is on the National Priorities List or the Comprehensive Environmental Response Compensation and Liability Information System, and no such property is a Resource Conservation and Reserve Act "permitted facility." No such property is permitted by the State of Maryland to be used as a landfill or disposal site of any type.

(d) To the best of the knowledge of SSWC and each Shareholder, and without limiting the generality of Section 3.10 of this Agreement, all applicable laws, ordinances, rules, regulations, decrees or orders of any Governmental Entity having to do with SSWC's businesses, including but not limited to water treatment, well-drilling, clean water or water composition and/or the handling, use and disposal of chemicals or chemical products or wastes, have been and are being fully complied with and adhered to.

(e) For purposes of this Agreement:

(i) "Environmental Claim" means any claims, action, cause of action, litigation, proceeding, order, decree, investigation or notice (written or oral) alleging potential liability or responsibility (including, without limitation, potential liability or responsibility for investigatory costs, cleanup costs, costs of compliance with laws, requirements, guidelines, or orders, governmental response costs, natural resources damages, property damages, personal injuries, or penalties) arising out of, based on or resulting from (a) the presence, or release into the environment, of any Material of Environmental Concern at any location, whether or not owned or operated by SSWC or (b) circumstances forming the basis of any violation, or alleged violation, of any Environmental Law.

(ii) "Environmental Laws" means all Federal, state and local laws, regulations, ordinances, rules, guidelines, orders, directives, judgments and determinations relating in any way to pollution or protection of human health or the environment (including, without limitation, ambient air, surface water, ground water, land surface or subsurface strata), including, without limitations, laws and regulations relating to emissions, discharges, releases or threatened releases of Materials of Environmental Concern, or otherwise relating to the manufacture, processing, distribution, use, treatment storage, disposal, transport or handling of Materials of Environmental Concern, as amended from time to time.

(iii) "Materials of Environmental Concern" means chemicals, pollutants, contaminants, hazardous material, hazardous substances, hazardous wastes, toxic substances, petroleum and petroleum products, and any substance controlled or regulated by any Environmental Law.

SECTION 3.14 Change in Control. SSWC is not a party to any contract, agreement or understanding which contains a "change in control," "potential change in

control” or similar provision. For purposes of this Agreement, “Change in Control” means any agreement, occurrence, or change in ownership or control of SSWC, such that any payment or obligation (whether of severance pay or otherwise) becomes due from SSWC to any person except for any payments called for or referred to by this Agreement. The consummation of the transactions contemplated by this Agreement will not (either alone or upon the occurrence of any additional acts or event) result in any payment (whether of severance pay or otherwise) becoming due from SSWC to any person, except for any payments called for or referred to by this Agreement.

SECTION 3.15 Intellectual Property. SSWC owns, or is licensed or otherwise has the full right to use, all copyrights, trademarks and service marks (including all applications and registrations therefor), trade names, computer software, patents (including applications therefor), and all other intellectual property that is necessary for the conduct of its business as heretofore conducted (collectively, the “Intellectual Property”), including but not limited to, a valid and subsisting authorized dealer agreement, dealer lease and rental service agreement (the “Dealer Agreements”) with EcoWater Systems, Inc., true and complete copies of which, with any and all amendments, addenda or modifications, is attached as Exhibit 2 hereto. There are no outstanding claims, judgments, settlements or proceedings against SSWC asserting the invalidity, abuse, misuse or unenforceability of the Intellectual Property or the Dealer Agreements.

#### SECTION 3.16 Contracts and Commitments.

(a) SSWC has no agreements, contracts, commitments, or restrictions that are material (i.e., over \$20,000 in amount or which are not terminable by SSWC on notice of not longer than thirty (30) days) to its business, prospects, financial condition, working capital, assets, liabilities (absolute, accrued, contingent or otherwise) or operations, except for those material contracts, copies of which have been provided to Chesapeake.

(b) There are no material (i.e., over \$10,000 in amount or which are not terminable by SSWC on notice of not longer than thirty (30) days) purchase contracts or commitments of SSWC, except for those material contracts, copies of which have been provided to Chesapeake.

(c) There are no outstanding material (i.e., over \$10,000 in amount or which are not terminable by SSWC on notice of not longer than thirty (30) days) sales contracts or commitments of SSWC, except for those material contracts, copies of which have been provided to Chesapeake.

(d) SSWC has no outstanding related party contracts or contracts with affiliates or other enterprises in common ownership with SSWC or by either of Shareholders, or will have no such contracts or arrangements by Closing.

(e) SSWC has no outstanding contracts with officers, directors or employees that are not cancelable by it on notice of not longer than thirty (30) days and without liability, penalty, or premium, except for any agreement or arrangement providing for the payment of any bonus or commissions based on sales or earnings.

(f) SSWC is not restricted by agreement from carrying on its business anywhere in the world, except as disclosed in writing to Chesapeake.

(g) SSWC's debts, obligations, and liabilities, including any guaranties or agreements to assume debts or liabilities of others, are shown on Exhibit 1. The debts, obligations, and liabilities represent the same indebtedness shown on the Unaudited Financial Statements, except for non-material changes to dollar amounts as a result of payments made or interest accrued in the ordinary course of SSWC's business since the Unaudited Financial Statements were prepared.

SECTION 3.17 Labor Relations. As of the date hereof, there is no strike or other labor dispute pending against SSWC. SSWC is not bound by or subject to (and none of its properties or assets is bound by or subject to) any written or oral, express or implied, contract, commitment or arrangement with any labor union, and no labor union has requested or sought to represent any of the employees, representative or agents of SSWC, nor is SSWC aware of any labor organization activity involving its employees.

SECTION 3.18 Employee Benefit Plans. SSWC has previously given to Chesapeake true and correct copies of its manuals, work rules, policies or other guidelines relating to employee compensation, retirement and severance and each employment or consulting contract to the extent they exist. There are no other significant employee benefit plans, programs or arrangements, maintained or contributed to by SSWC, other than those listed at Exhibit 3.

SECTION 3.19 Personnel. SSWC has furnished to Chesapeake a list of the names and current salaries of each officer and employee of SSWC as of the date of this Agreement, including a complete and correct list of all written employment, compensation, severance, consulting or indemnification contracts between SSWC and its present or former employees, officers, directors and consultants to the extent SSWC has any continuing obligations thereunder. SSWC has made available to Chesapeake true and correct copies of all such agreements.

SECTION 3.20 Insurance. SSWC has supplied to Chesapeake an accurate and complete list of all policies of fire, liability, workmen's compensation and other forms of insurance owned or held by SSWC. All such policies are in full force and effect, all premiums with respect thereto covering all periods up to and including the Effective Time will have been paid, and no notice of cancellation of termination has been received with respect to any such policy. All known claims, if any, made against SSWC that are covered by insurance have been disclosed to and accepted by the appropriate insurance



companies have been previously disclosed to Chesapeake and, to the best knowledge of SSWC, are being defended by such appropriate insurance companies.

SECTION 3.21 Receivables. All accounts and notes due and uncollected as reflected on the Unaudited Financial Statements, and all accounts and notes due and uncollected and arising subsequent to November 30, 1997: (i) have arisen in the ordinary course of business of SSWC; and (ii) represent valid obligations due to SSWC enforceable in accordance with their terms. SSWC has previously made available to Chesapeake lists of the aging and amounts of all accounts and notes due and uncollected at November 30, 1997. SSWC has no agreements, arrangements or commitments with related parties (including stockholders, directors and officers), other than indebtedness that was entered into on an arm's length basis and which is fully reflected on the Unaudited Financial Statements which are a part hereof.

#### SECTION 3.22 Real Property.

(a) Attached as Exhibit 4 is a true and complete list and description of the real property owned by SSWC and used in the business of SSWC, and the buildings, improvements and structures located thereon ("Real Property").

(b) As of the Effective Time, SSWC has or will have good and marketable title to the Real Property in fee simple and to the structures and fixtures attached or appurtenant to the Real Property, free and clear of all Liens, except Permitted Liens.

(c) Neither SSWC nor any Shareholder has received any notice of or writing referring to any requirements or demands by any insurance company that has issued a policy covering any part of any Real Property or by any board of fire underwriters or other body exercising similar functions that any repairs or work be done on any part of the Real Property.

SECTION 3.23 Absence of Certain Payments. Neither SSWC, or any of its affiliates or any of their respective officers, directors, employees or agents or other people acting on behalf of any of them, have engaged in any activity prohibited by the United States Foreign Corrupt Practices Act of 1977 or any other similar law, or, without limiting the generality of the preceding clause, used any corporate or other funds for unlawful contributions, payments, gifts or entertainment, or made any unlawful expenditure relating to political activity to government officials or others.

SECTION 3.24 Shares are Unencumbered. Shareholders' shares of SSWC to be exchanged in accordance with this Agreement are not pledged, hypothecated, or otherwise encumbered, are not subject to any lien of judgment, attachment or levy by any creditor, other person, court of competent jurisdiction or any Governmental Entity for any reason including but not limited to non-payment of any debt, obligation, liability or any Taxes, and are otherwise free and clear of every claim or obligation of any kind. Neither Shareholder is under any contract, agreement, restriction or disability of any kind which

would act as a bar or impediment to the exchange and transfer of shares of the SSWC Common Stock as contemplated herein.

#### ARTICLE IV REPRESENTATIONS AND WARRANTIES OF CHESAPEAKE

Chesapeake represents and warrants to SSWC and the Shareholders as follows:

SECTION 4.1 Corporate Organization. Each of Chesapeake and CPK Sub-B is a corporation duly organized, validly existing and in good standing under the laws of the jurisdiction of its incorporation and has all requisite corporate power and authority to own, lease and operate its properties and to carry on its business as now being conducted. Chesapeake is duly qualified or licensed to do business and is in good standing in each jurisdiction in which the property owned, leased or operated by it or the nature of the business conducted by it makes such qualification or licensing necessary, unless failure to do so would not result in a material adverse effect (for purposes of this Agreement, the phrase "material adverse effect on Chesapeake" will mean such effect on Chesapeake and its subsidiaries, taken as a whole). The Certificate of Incorporation and By-laws of Chesapeake, as currently in effect, are filed as exhibits to Chesapeake's Annual Report on Form 10-K. Chesapeake has heretofore delivered to SSWC and Shareholders accurate and complete copies of its Certificate of Incorporation and By-laws.

SECTION 4.2 Authority Relative to this Agreement. Each of Chesapeake and CPK Sub-B has full corporate power and authority to execute and deliver this Agreement and to consummate the transactions contemplated hereby. The execution and delivery of this Agreement and the consummation of the transactions contemplated hereby have been duly and validly authorized and approved by the Boards of Directors of Chesapeake and CPK Sub-B and by Chesapeake as the sole stockholder of CPK Sub-B and no other corporate proceedings on the part of Chesapeake or CPK Sub-B are necessary to authorize this Agreement or to consummate the transactions so contemplated. This Agreement has been duly and validly executed and delivered by each of Chesapeake and CPK Sub-B and constitutes a legal, valid and binding agreement of each of Chesapeake and CPK Sub-B, enforceable against each of Chesapeake and CPK Sub-B in accordance with its terms.

SECTION 4.3 Consents and Approvals; No Violations. Except for the filing and recordation of the Articles of Merger, as required by the MGCL, and the filing with the Delaware Public Utilities Commission, no filing with or notification to and no permit, authorization, consent, waiver or approval of, any Governmental Entity, is necessary for the consummation by Chesapeake of the transactions contemplated by this Agreement. Neither the execution and delivery of this Agreement by Chesapeake or CPK Sub-B nor the consummation by Chesapeake and CPK Sub-B of the transactions contemplated hereby nor compliance by Chesapeake or CPK Sub-B with any of the provisions hereof will: (i) conflict with or result in any breach of any provision of the Certificate of

Incorporation or By-Laws of Chesapeake or any of its subsidiaries; (ii) result in a violation or breach of, or constitute a default under, any of the terms, conditions or provisions of any note, bond, mortgage, indenture, license, contract, agreement or other instrument or obligation to which Chesapeake or any of its subsidiaries is a party or by which any of them or any of their respective properties or assets may be bound; (iii) violate any order, writ, injunction, decree, or statute applicable to Chesapeake or CPK Sub-B or any of their properties or assets; or (iv) result in a violation of any rule or regulation applicable to Chesapeake or CPK Sub-B or any of their properties or assets, unless such violation would not result in a material adverse effect on Chesapeake or CPK Sub-B or the Merger.

SECTION 4.4 SEC Reports. Chesapeake has filed on a timely basis all required forms, reports, registration statements and documents with the U.S. Securities and Exchange Commission ("SEC") since January 1, 1994 (collectively, the "Chesapeake SEC Reports"), each of which has complied in all materials respects with all applicable requirements of the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"), as each was in effect on the dates so filed. At the request of SSWC or either of the Shareholders, Chesapeake will deliver Form 10-K's, proxy statements, Quarterly Reports, Form 10-Q's, Annual Reports to Shareholders and/or Form 8-K's as duly filed in the last three (3) fiscal years. The audited consolidated financial statements and unaudited consolidated interim financial statements of Chesapeake included in the Chesapeake SEC Reports are true, correct and complete in all material respects.

SECTION 4.5 CPK Sub-B. CPK Sub-B has not conducted any operations or incurred any liabilities or obligations other than arising under or in connection with its formation and the transactions contemplated by this Agreement.

SECTION 4.6 Chesapeake Shares. All of the shares of Chesapeake Common Stock to be issued in connection with the Merger will, at the time of such issuance, be validly issued, fully paid and nonassessable and free of preemptive rights and free of any adverse liens, claims, charges or encumbrances.

SECTION 4.7 Disclosure. No representation or warranty by Chesapeake in this Agreement, and no statement contained in any document (including without limitation, the Chesapeake SEC Reports), schedule or certificate furnished or to be furnished by Chesapeake to SSWC or the Shareholders pursuant to the provisions hereof or in connection with the transactions contemplated hereby, contains any untrue statement of material fact or omits to state any material fact necessary in order to make the statements herein or therein, in light of the circumstances under which they were made, not misleading.

SECTION 4.8 Employee Benefit Plans. Chesapeake has previously given to SSWC true and correct copies of its personnel manuals, rules, policies or other guidelines relating to employee compensation and retirement, for those benefits plans and guidelines

that will be extended to SSWC employees, including Shareholder Dashiell J. Shannahan, following the Merger. Except as previously disclosed to SSWC and Shareholders in writing, there are no other significant employee benefit plans, programs or arrangements, maintained or contributed to by Chesapeake (excluding the pension plan, severance, employment or consulting contracts, and also excluding the Employment and Non-Competition Agreement attached hereto as Exhibit 7).

SECTION 4.9 Absence of Certain Changes. Except as and to the extent set forth in the Chesapeake SEC Reports since September 30, 1997, Chesapeake has not:

(a) suffered any material adverse change ("Chesapeake Material Adverse Change"). As used herein, Chesapeake Material Adverse Change means (i) any material adverse change in the nature of Chesapeake's business, assets, financial condition, results of operations, net income, or prospects, (ii) the loss of a contract which would have a material adverse effect on Chesapeake, and (iii) any change that creates a material limitation on the ability of Chesapeake to conduct its business substantially as heretofore conducted. For purposes of this Section 4.9 only, material adverse effect on net income shall mean a decrease of ten percent or more in net income for Chesapeake and its consolidated subsidiaries in any calendar quarter from the comparable calendar quarter in the preceding fiscal year, excluding any decrease reasonably attributable to (i) temperature fluctuations or (ii) other matters previously disclosed in the Chesapeake SEC Reports;

(b) agreed or planned, whether in writing or otherwise, to take any action that would result in any condition described in Section 4.9(a) of this Agreement; or

(c) received notice or obtained knowledge of any circumstance that would result in any condition described in Section 4.9(a) of this Agreement.

## ARTICLE V COVENANTS OF SSWC AND SHAREHOLDERS

SSWC and each of the Shareholders, severally and not jointly, each covenants and agrees as follows:

SECTION 5.1 Conduct of Business Pending the Merger. Except as otherwise specifically provided in this Agreement or as otherwise consented to in writing by Chesapeake, from the date of this Agreement to the Effective Time, SSWC will (and each Shareholder will cause SSWC to) conduct its operations only in the ordinary and usual course of business and consistent with past practices and will preserve intact its present business organization, take all reasonable efforts to keep available the services of its present officers, employees and consultants and preserve its present relationships with licensors, licensees, customers, suppliers, employees, labor organizations and others with whom it has a significant business relationship. Without limiting the generality of the

foregoing, SSWC will not, directly or indirectly (and each Shareholder will cause SSWC not to), from the date of this Agreement to the Effective Time, without the prior written consent of Chesapeake:

(a) adopt any amendment to or otherwise change its Articles of Incorporation or By-laws or other organizational documents;

(b) authorize for issuance, sale, pledge, disposition or encumbrance, or issue, sell, pledge, dispose of or encumber (whether through the issuance or granting of options, warrants, commitments, subscriptions, rights to purchase, convertible securities or otherwise), any capital stock of any class or any other securities of, or any other ownership interest in, SSWC or amend any of the terms of any such securities or agreements outstanding on the date hereof;

(c) reclassify, combine, split or subdivide any shares of its capital stock, declare, set aside or pay any dividend or other distribution (whether in cash, securities or property or any combination thereof) in respect of any class or series of its capital stock;

(d) redeem, purchase or otherwise acquire, or propose or offer to redeem, purchase or otherwise acquire, any outstanding shares of SSWC Common Stock or other securities of SSWC;

(e) organize any new subsidiary, acquire any capital stock or equity securities of any corporation or acquire any equity or ownership interest (financial or otherwise) in any business;

(f) (i) incur, assume or prepay any material liability, including, without limitation, any indebtedness for borrowed money except in the ordinary course of business and consistent with past practice, and in no event in excess of \$50,000, (ii) assume, guarantee, endorse or otherwise become liable or responsible (whether directly, contingently or otherwise) for obligations of any third party, (iii) make any loans, advances or capital contributions to, or investments in, any third party, (iv) mortgage or pledge any of its material properties or assets, tangible or intangible, or create any material Lien thereupon other than Permitted Liens, or (v) authorize any new capital expenditures which, individually or in the aggregate, are in excess of \$20,000;

(g) license (except to end users in the ordinary course of business, consistent with past practice and pursuant to a written license agreement) or otherwise transfer, dispose of, permit to lapse or otherwise fail to preserve any of SSWC's Intellectual Property, or dispose of or disclose to any person any trade secret, formula, process or know-how not heretofore a matter of public knowledge;

(h) enter into any agreement, contract, commitment or transaction other than in the ordinary course of business, consistent with past practices, that would contravene the

representation set forth in Section 3.16 hereof, if entered into prior to the date of this Agreement;

(i) increase the compensation payable or to become payable to its officers or employees, except for increases in salary or wages of non-officer employees of SSWC in accordance with past practices, or grant any severance or termination pay or stock options to, or enter into any employment or severance agreement with any director, officer, or other employee of SSWC, or establish, adopt, enter into, or amend any collective bargaining, bonus, profit sharing, thrift, compensation, stock option, restricted stock, pension, retirement, deferred compensation, employment, termination, severance, or other plan, agreement, trust, fund, policy, or arrangement for the benefit of any current or former directors, officers, or employees;

(j) cancel any debts or waive, release or relinquish any material contract rights or other rights of substantial value other than in the ordinary course of business, consistent with past practices;

(k) authorize, recommend, propose or enter into or announce an intention to authorize, recommend, propose or enter into an agreement in principle or a definitive agreement with respect to any merger, consolidation, liquidation, dissolution, or business combination, any acquisition of a material amount of property or assets or securities or any disposition of a material amount of property or assets or securities;

(l) make any material change with respect to accounting policies or procedures except as may be required by generally accepted accounting principles;

(m) pay, discharge or satisfy any claims, liabilities or obligations (absolute, accrued, asserted or unasserted, contingent or otherwise) other than the payment, discharge or satisfaction in the ordinary course of business, consistent with past practice, of liabilities reflected or reserved against in the Unaudited Financial Statements or incurred in the ordinary course of business consistent with past practices since the date hereof; or

(n) commit or agree (in writing or otherwise) to take any of the foregoing actions or any action which would make any representation or warranty in this Agreement untrue or incorrect, including as of the date hereof and as of the Effective Time.

SECTION 5.2 Access to Information. Upon reasonable notice and subject to restrictions contained in confidentiality agreements with third parties to which SSWC is subject (from which SSWC shall use reasonable efforts to be released), SSWC shall afford to the officers, employees, accountants, counsel, environmental consultants and other representatives of Chesapeake, reasonable access, during normal business hours during the period prior to the Effective Time, to all its properties, books, contracts, commitments and records and, during such period, SSWC shall furnish promptly to

Chesapeake all information concerning its business, properties and personnel as Chesapeake may reasonably request.

SECTION 5.3 No Solicitation. From the execution hereof until the Effective Time, Shareholders and SSWC will not initiate or solicit, directly or indirectly, any inquiries or the making of any proposal with respect to, or engage in negotiations concerning, provide any information or data to, or have any discussions with any Third Party (as hereinafter defined) relating to, any public offering of securities of, or acquisition, business combination or purchase of all or any significant portion of the properties or assets of, or any equity interest in, SSWC (an "Acquisition Proposal"). Shareholders and SSWC will immediately cease any existing activities, discussions or negotiations with any Third Party conducted heretofore with respect to any Acquisition Proposal. Shareholders and SSWC shall immediately notify Chesapeake if, subsequent to the date hereof, any such negotiations, provision of information or data or discussions are entered into or made or any such inquiries are received in respect thereof, and shall provide details with, including the identity of such Third Party and the price and terms of any Acquisition Proposal. As used in this Agreement, the term "Third Party" means any "group", as such terms are defined in Section 13(d) of the Exchange Act, other than Chesapeake or any affiliate of Chesapeake.

SECTION 5.4 Further Information. From the execution hereof until the Effective Time, as soon as practicable after such information becomes available, and in any event not later than thirty (30) days after the end of each fiscal month, SSWC shall provide to Chesapeake an unaudited balance sheet as of the end of such month and the related consolidated statements of results of operations and statements of cash flows for such period.

SECTION 5.5 Affiliates. Prior to the execution of this Agreement, SSWC shall deliver to Chesapeake a letter substantially in the form attached hereto as Exhibit 5A identifying all persons who may be deemed, as of the date of this Agreement, "affiliates" of SSWC for purposes of Rule 145 under the Securities Act. SSWC shall cause each person named in such letter to deliver a written agreement substantially in the form attached hereto as Exhibit 5B.

## ARTICLE VI COVENANTS OF CHESAPEAKE

Chesapeake covenants and agrees as follows:

SECTION 6.1 Employment Matters. It is Chesapeake's present intention to integrate, following the Effective Time, certain employee benefit plans currently maintained by Chesapeake and its subsidiaries and SSWC, respectively. To the extent that SSWC employees become participants in any such plans of Chesapeake and its subsidiaries ("Chesapeake Plans") following the Effective Time, SSWC employees shall

be credited under the Chesapeake Plans for prior years of service with SSWC for purposes of eligibility and vesting, to the extent such service was recognized by SSWC under any similar employee benefit plan. With respect to Chesapeake's pension plan, SSWC employees will not become participants. With respect to the Chesapeake 401(k) Plan, SSWC employees will not be entitled to retroactive matching contributions for years of service prior to the Effective Time.

SECTION 6.2 Release of Personal Guaranties. At the Effective Time, Chesapeake shall pay all indebtedness of SSWC that has been reasonably incurred in connection with its business and is guaranteed or co-signed by a Shareholder. Exhibit 6 hereof includes a complete schedule of all such indebtedness currently outstanding.

SECTION 6.3 Listing of Shares. Within thirty (30) days of Closing Chesapeake shall apply to have the Chesapeake shares to be issued pursuant to this Agreement listed on the New York Stock Exchange.

SECTION 6.4 Registration of Shares. In the event that Chesapeake shall, within the twelve (12) months immediately following the Effective Date, file with the SEC a registration statement with respect to any shares of Chesapeake to be issued in connection with any other secondary offering large enough to warrant such registration, such registration statement shall also include the Chesapeake Common Stock to be issued pursuant to this Agreement. In the event the Chesapeake Common Stock is included in a registration statement in accordance with this Section 6.4, Chesapeake shall give prompt written notice thereof to Shareholders.

SECTION 6.5 Notice of Post-Merger Financial Results. Chesapeake shall give prompt written notice to Shareholders of the publication of financial results covering at least thirty (30) days of post-Merger combined operations.

## ARTICLE VII MUTUAL COVENANTS

SSWC and each of the Shareholders, Chesapeake and CPK Sub-B, Inc., jointly and severally and each to the other, covenant and agree as follows:

SECTION 7.1 Reasonable Efforts. Subject to the terms and conditions of this Agreement, each of the parties hereto agrees to use all reasonable efforts to take, or cause to be taken, all actions, and to do, or cause to be done, all things necessary, proper or advisable to assure that all conditions to Closing set forth in Article VIII of this Agreement are satisfied as expeditiously as possible including, without limitation, the preparation and filing of all forms, registrations and notices required to be filed to consummate the transactions contemplated hereby and the taking of such actions as are necessary to obtain any requisite approvals, consents, orders, exemptions, or waivers by any public or private third party. Each party shall promptly consult with the other with



respect to, provide any necessary information with respect to, and provide the other (or its counsel) copies of all filings made by such party with any Governmental Entity in connection with this Agreement and the transactions contemplated hereby.

SECTION 7.2 Brokers or Finders. No agent, broker, investment banker, financial advisor or other firm or person is or will be entitled to any brokers' or finder's fee or any other commission or similar fee in connection with any of the transactions contemplated by this Agreement.

SECTION 7.3 Notification of Certain Matters. SSWC and each of the Shareholders shall give prompt notice to Chesapeake and CPK Sub-B, and Chesapeake and CPK Sub-B shall give prompt notice to SSWC and Shareholders, of the occurrence (or non-occurrence) of any event which would be likely to cause any representation or warranty contained in this Agreement to be untrue or inaccurate in any respect (including as of the Effective Time) and of any failure of either party to comply with or satisfy any covenant, condition or agreement to be complied with or satisfied by it hereunder; provided, however, that delivery of any notice pursuant to this Section 7.3 shall not limit or otherwise affect the remedies available to either party hereunder.

SECTION 7.4 Fees and Expenses. Whether or not the Merger is consummated, all costs and expenses incurred in connection with this Agreement and the transactions contemplated hereby, including the parties' respective legal fees, shall be paid by the party incurring such expenses, except that Chesapeake will reimburse such expenses of SSWC or Shareholders up to a maximum of \$25,000 consisting of SSWC's and Shareholders' legal and accounting fees in connection with the transaction contemplated hereby, which shall be paid within sixty (60) days after the Effective Time, or within thirty (30) days after notice is given by a party hereto of failure of a condition or other provision under which this Agreement may lawfully be terminated.

SECTION 7.5 Further Assurances. After the Effective Time, Chesapeake and the Shareholders shall from time to time, at the request of the other party and without further cost or expense to the requesting party, execute and deliver such other instruments of conveyance and transfer and take such other actions as such other party may reasonably request in order more effectively to carry out this Agreement.

SECTION 7.6 Right to Require Opinion of Counsel on Sale of Stock. Notwithstanding the terms of the legend, described in Exhibit 10 hereto, imprinted on the certificates representing the Chesapeake Common Stock (hereinafter the "Certificates"), after the expiration of one (1) year following the date on which the Certificates are delivered to the Shareholders, Chesapeake shall not require an opinion of legal counsel, at the expense of the offeror or transferor of the Chesapeake Common Stock (hereinafter the "Seller"). As to the availability of an exemption from registration of the Chesapeake Common Stock under the Securities Act, as the Act applies to the Seller at the time of transfer, the Seller shall provide Chesapeake with a copy of (i) the seller's representation letter for sale of restricted or control securities under Rule 144 provided to the broker-

dealer effecting the transfer, and (ii) the broker-dealer's certificate that it has complied with the "manner of sale" provisions contained in Rule 144(f).

## ARTICLE VIII CONDITIONS

SECTION 8.1 Conditions to Each Party's Obligation to Effect the Merger. The respective obligations of each party to effect the Merger shall be subject to the satisfaction at or prior to the Closing of the following conditions:

(a) No statute, rule, regulation, executive order, decree or injunction, by any court or Governmental Entity of competent jurisdiction, shall be in effect that prohibits the consummation of the Merger.

(b) The Closing shall have taken place no later than March 31, 1998.

SECTION 8.2 Conditions of Obligations of SSWC and the Shareholders. The obligation of SSWC and the Shareholders to effect the Merger is further subject to the satisfaction at or prior to the Closing of the following conditions, unless waived by SSWC and the Shareholders:

(a) The representations and warranties of Chesapeake set forth in this Agreement shall be true and correct in all material respects as of the date of this Agreement and as of the Closing .

(b) Chesapeake shall have performed and complied, in all material respects, with all obligations, covenants and conditions required to be performed or complied with by it under this Agreement at or prior to the Closing.

(c) Chesapeake shall have obtained all consents, approvals, authorizations and permits required from third parties and any Governmental Entity (applicable to Chesapeake and its subsidiaries) necessary for the consummation by Chesapeake of the transactions contemplated by this Agreement.

(d) Chesapeake shall have executed and delivered an Employment and Non-Competition Agreement with Dashiell J. Shannahan substantially in the form of Exhibit 7 attached hereto.

(e) SSWC and the Shareholders shall have received from legal counsel for Chesapeake an opinion substantially in the form of Exhibit 8 attached hereto.

(f) From the date of this Agreement through the Effective Time, Chesapeake shall not have suffered a Chesapeake Material Adverse Change.

(g) Shareholders shall have received an opinion letter from a certified public accountant of their choosing, to the effect that the exchange of Shareholders' SSWC Common Stock for Chesapeake Common Stock, as contemplated by this Agreement, may be properly treated by Shareholders for their individual federal income tax purposes as a "Tax Free Exchange" according to the Code.

SECTION 8.3 Conditions of Obligations of Chesapeake. The obligation of Chesapeake to effect the Merger is further subject to the satisfaction at or prior to the Closing of the following conditions, unless waived by Chesapeake:

(a) The representations and warranties of SSWC and the Shareholders set forth in this Agreement shall be true and correct in all material respects as of the date of this Agreement and as of the Closing.

(b) SSWC and the Shareholders shall have performed and complied with, in all material respects, all obligations, covenants and conditions required to be performed or complied with by it under this Agreement at or prior to the Closing.

(c) SSWC and the Shareholders shall have obtained all consents, approvals, authorizations and permits required from third parties and any Governmental Entity (applicable to SSWC) necessary for the consummation by SSWC and the Shareholders of the transactions contemplated by this Agreement.

(d) Dashiell J. Shannahan shall have executed and delivered an Employment and Non-Competition Agreement with Chesapeake substantially in the form of Exhibit 7 attached hereto.

(e) Chesapeake shall have received from counsel to the Shareholders and to SSWC an opinion substantially in the form of Exhibit 9 attached hereto.

(f) Chesapeake shall have received from each Shareholder an investment letter, substantially in the form of Exhibit 10 attached hereto.

(g) From the date of this Agreement through the Effective time, SSWC shall not have suffered a SSWC Material Adverse Change.

(h) All necessary approvals from the Delaware Public Service Commission regarding the issuance of the shares of Chesapeake Common Stock shall have been granted by final order.

(i) SSWC and Shareholders shall: adopt replacement By-laws in form and substance acceptable to Chesapeake; qualify SSWC to do business in Delaware and Virginia, and effect a trade name filing for SSWC entitling it to the trade name "Tolan Water Service" in Maryland, Delaware and Virginia.

(j) The results of the due diligence investigation being conducted by Chesapeake with respect to SSWC, shall be acceptable to Chesapeake, in Chesapeake's sole discretion; provided however that this condition shall remain in effect no later than midnight March 23, 1997, or a date ten (10) days prior to settlement, whichever is later (the "Due Diligence Deadline"). Chesapeake shall be deemed to have found the results of its due diligence investigation acceptable unless it gives prompt written notice to the contrary to SSWC and Shareholders within forty-eight (48) hours after the Due Diligence Deadline.

## ARTICLE IX SURVIVAL AND INDEMNIFICATION

SECTION 9.1 Survival of Representations and Warranties. All statements, certifications, representations, warranties, covenants, agreements and obligations provided for herein shall survive beyond the Effective Time and continue (and shall not in any manner be affected or impaired by the consummation of the transactions contemplated by this Agreement) until the time specified in Section 9.2 hereof or until the termination of this Agreement pursuant to Section 10.1.

### SECTION 9.2 Indemnification.

#### (a) Indemnity by Chesapeake.

(i) Chesapeake shall indemnify and defend and hold each Shareholders harmless from and against all claims, liabilities, damages, losses and expenses (including reasonable attorneys' fees) of every kind and character (exclusive of any amounts covered by Section 9.2(b)) resulting from or relating to or arising out of the inaccuracy, nonfulfillment, nonperformance or breach of any representation, warranty, covenant, agreement or obligation of Chesapeake contained herein.

(ii) No Shareholder shall have any claim for indemnification hereunder unless such claim is asserted by written notice and resolved not later than the earlier of (A) one year following the Effective Time or (B) the date on which an independent audit report on Chesapeake is issued which reflects the Merger. No indemnification shall be payable to Shareholders in excess of \$200,000, exclusive of amounts payable as a result of a knowing, fraudulent, or intentional breach by Chesapeake. This right of indemnification shall be subject to a \$50,000 deductible, i.e., the first \$50,000 of any such claim for indemnification hereunder shall be absorbed by the indemnitee as a measure agreed upon by the parties to discourage minor, insignificant or frivolous claims.

#### (b) Indemnity by the Shareholders.

(i) Shareholders shall indemnify and defend and hold Chesapeake and its affiliates harmless from and against all claims, liabilities, damages, losses and expenses

(including reasonable attorneys' fees) of every kind and character (exclusive of any amounts covered by Section 9.2(a)) resulting from or relating to or arising out of the inaccuracy, nonfulfillment, nonperformance or breach of any representation warranty, covenant, agreement or obligation of Shareholders or SSWC contained herein.

(ii) Chesapeake shall have no claim for indemnification hereunder unless such claim is asserted by written notice and resolved not later than the earlier of (A) one year following the Effective Time or (B) the date on which an independent audit report on Chesapeake is issued which reflects the Merger. No indemnification shall be payable to Chesapeake in excess of \$200,000 exclusive of amounts payable as a result of knowing, fraudulent or intentional breach by either Shareholder. This right of indemnification shall be subject to a \$50,000 deductible, i.e., the first \$50,000 of any such claim for indemnification hereunder shall be absorbed by the indemnitee as a measure agreed upon by the parties to discourage minor, insignificant or frivolous claims.

(c) The parties' respective rights to indemnification hereunder may not be transferred or assigned, except between Shareholders themselves, or by will, intestate succession, or decree of a court of competent jurisdiction.

(d) Amounts due to or by Chesapeake under this Article IX shall be paid, to the extent held or other limit prescribed by law or regulation, in Chesapeake Common Stock. For purposes of this Section 9.2(d), the value of such Chesapeake Common Stock shall be deemed to be the closing market price of the Common Stock as of the Effective Time.

## ARTICLE X TERMINATION AND AMENDMENT

SECTION 10.1 Termination by Mutual Consent. This Agreement may be terminated at any time prior to the Effective Time by mutual consent of Chesapeake, SSWC and the Shareholders.

SECTION 10.2 Other Grounds for Termination. This Agreement may be terminated at any time prior to the Effective Time:

(a) by either Chesapeake or the Shareholders, if the Closing shall not have been consummated on or before March 31, 1998 (unless the failure to consummate the merger by such date shall be due to the action or failure to act of the party seeking to terminate); or

(b) by either Chesapeake, SSWC or the Shareholders, if any permanent injunction or other order of a court or other competent authority preventing the consummation of the Merger shall have become final and nonappealable.

SECTION 10.3 Effect of Termination. In the event of the termination and abandonment of this Agreement pursuant to Section 10.2 hereof, this Agreement shall forthwith become void and have no effect, without any liability on the part of any party hereto or its affiliates, directors, officers or stockholders. Notwithstanding the foregoing, nothing contained in this Section 10.3 shall relieve any party from liability for any material breach of any covenant of this Agreement or any material breach or misrepresentation of the representations or warranties contained herein.

SECTION 10.4 Amendment. This Agreement may be amended by the parties hereto at any time prior to the Effective Time. This Agreement may not be amended except by an instrument in writing executed by all the parties hereto.

SECTION 10.5 Extension; Waiver. At any time prior to the Effective Time, the parties may, to the extent legally allowed: (i) extend the time for the performance of any of the obligations or other acts of the other parties hereto, (ii) waive any inaccuracies in the representations and warranties of the other parties hereto contained herein or in any document delivered pursuant hereto and (iii) waive compliance with any of the agreements or conditions contained herein by the other parties hereto. Any agreement on the part of a party hereto to any such extension or waiver shall be valid only if set forth in a written instrument.

## ARTICLE XI MISCELLANEOUS

SECTION 11.1 Notices. All notices and other communications hereunder shall be in writing, and shall be deemed given upon receipt if delivered personally, sent by facsimile transmission or by certified or registered mail, return receipt requested, or by a nationally recognized private overnight courier to the parties at the following addresses:

(a) if to SSWC, to:

Sam Shannahan Well Co., Inc., d/b/a  
Tolan Water Service  
Attention: Duke Shannahan, President  
716 Naylor Mill Road  
Salisbury, MD 21801

with a copy to:

H. Michael Hickson, Esquire  
Banks, Nason & Hickson, P.A.  
113 Baptist Street  
Salisbury, MD 21801

(b) if to the Shareholders to:

Dashiell J. Shannahan  
Joyce C. Shannahan  
917 Camden Avenue  
Salisbury, MD 21801

with a copy to:

H. Michael Hickson, Esquire  
Banks, Nason & Hickson, P.A.  
113 Baptist Street  
Salisbury, MD 21801

(c) if to Chesapeake, to:

Chesapeake Utilities Corporation  
Attention: John R. Schimkaitis, President  
909 Silver Lake Boulevard  
Dover, Delaware 19904

with a copy to:

Victor H. Laws, III, Esquire  
Laws & Laws, P.A.  
209 East Main Street  
P.O. Box 75  
Salisbury, MD 21803-0075

SECTION 11.2 Descriptive Headings. The descriptive headings herein are inserted for convenience only and are not intended to be part of or to affect the meaning or interpretation of this Agreement.

SECTION 11.3 Counterparts. This Agreement may be executed in two or more counterparts, all of which shall be considered one and the same agreement and shall become effective when two or more counterparts have been signed by each of the parties and delivered to the other parties, it being understood that all parties need not sign the same counterpart.

SECTION 11.4 Entire Agreement; Successors and Assigns.

(a) This Agreement constitutes the entire agreement and supersedes all prior agreements and understanding, both written and oral, among the parties with respect to the subject matter hereof.

(b) This Agreement shall be binding upon, and inure to the benefit of the parties hereto and their heirs, successors, and permitted assigns. As used herein, the successors of a party shall include, but not be limited to, any successor by way of merger, consolidation, sale or transfer of all or substantially all of its assets (pursuant to liquidation or otherwise) or similar reorganization. In no event may either Shareholder assign any rights or duties under this Agreement, except between Shareholders themselves, or by will, intestate succession, or decree of a court of competent jurisdiction, or except with Chesapeake's written consent.

SECTION 11.5 Governing Law. This Agreement shall be governed and construed in accordance with the laws of the State of Maryland.

SECTION 11.6 Specific Performance. The parties hereto agree that if any of the provisions of this Agreement were not performed in accordance with their specific terms or were otherwise breached, irreparable damage would occur, no adequate remedy at law would exist and damages would be difficult to determine, and that the parties shall be entitled to specific performance of the terms hereof, in addition to any other remedy at law or equity.

SECTION 11.7 Publicity. Chesapeake may issue or cause the publication of any press release or other public announcement or make any filing with the SEC with respect to the transactions contemplated by this Agreement as it deems appropriate. Any such press release, public announcement or other publication or communication shall be non-defamatory as towards SSWC and Shareholders. Neither SSWC nor Shareholders shall issue or cause the publication of any press release or other public announcement with respect to the transactions contemplated by this Agreement without the prior approval of Chesapeake.

SECTION 11.9 Confidentiality Agreements. At the Effective Time, the Confidentiality Agreements dated January 28, 1998 between Chesapeake and SSWC and the Shareholders will terminate and have no further force or effect.

**REST OF THIS PAGE IS INTENTIONALLY LEFT BLANK**



IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be signed (where applicable by their respective officers thereunto duly authorized), as of the date first written above.

ATTEST:

Beth W. Cooper

CHESAPEAKE UTILITIES  
CORPORATION

By: John R. Schimkaitis (SEAL)  
John R. Schimkaitis, President

ATTEST:

Dashiell J. Shannahan

SAM SHANNAHAN WELL CO., INC.,  
d/b/a TOLAN WATER SERVICE

By: Dashiell J. Shannahan (SEAL)  
Dashiell J. Shannahan, President

ATTEST:

Beth W. Cooper

CPK SUB-B, INC.  
By: John R. Schimkaitis (SEAL)  
Authorized Officer

WITNESS:

Dashiell J. Shannahan

Dashiell J. Shannahan (SEAL)  
Dashiell J. Shannahan

WITNESS:

Joyce C. Shannahan

Joyce C. Shannahan (SEAL)  
Joyce C. Shannahan

STATE OF DELAWARE  
COUNTY OF KENT:

I HEREBY CERTIFY that on this 20<sup>th</sup> day of March, 1998, before me, the undersigned officer, personally appeared John R. Schimkaitis, President of Chesapeake Utilities Corporation, and on its behalf did acknowledge the foregoing Agreement and Plan of Merger to be the act and deed of said corporation.

AS WITNESS my hand and notarial seal.

My Commission Expires: 10/21/01

Hedi W. Watkins  
Notary Public

STATE OF DELAWARE  
COUNTY OF KENT:

I HEREBY CERTIFY that on this 20<sup>th</sup> day of March, 1998, before me, the undersigned officer, personally appeared John R. Schimke Authorized Officer of CPK Sub-B, Inc., and on its behalf did acknowledge the foregoing Agreement and Plan of Merger to be the act and deed of said corporation.

AS WITNESS my hand and notarial seal.

My Commission Expires: 10/21/01

Hedi W. Watkins  
Notary Public

STATE OF MARYLAND  
COUNTY OF WICOMICO:

I HEREBY CERTIFY that on this 20 day of March, 1998, before me, the undersigned officer, personally appeared Dashiell J. Shannahan, President of Sam Shannahan Well Co., Inc., d/b/a Tolan Water Services, and on its behalf did acknowledge the foregoing Agreement and Plan of Merger to be the act and deed of said corporation.

AS WITNESS my hand and notarial seal.

My Commission Expires: 10/6/01

Lana Conway  
Notary Public

STATE OF MARYLAND  
COUNTY OF WICOMICO:

I HEREBY CERTIFY that on this 20 day of March, 1998, before me, the undersigned officer, personally appeared Dashiell J. Shannahan, known to me or satisfactorily identified to be the person whose name is subscribed to the foregoing Agreement and Plan of Merger, and acknowledged that he executed the same for the purposes therein contained.

AS WITNESS my hand and notarial seal.

My Commission Expires: 10/6/01

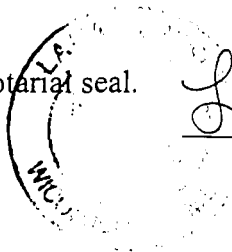
Lana Conway  
Notary Public

STATE OF MARYLAND  
COUNTY OF WICOMICO:

I HEREBY CERTIFY that on this 20 day of March, 1998,  
before me, the undersigned officer, personally appeared Joyce C. Shannahan, known to  
me or satisfactorily identified to be the person whose name is subscribed to the foregoing  
Agreement and Plan of Merger, and acknowledged that he executed the same for the  
purposes therein contained.

AS WITNESS my hand and notarial seal.

My Commission Expires 10/6/01



Lara Conway  
Notary Public

**CHESAPEAKE** RECEIVED  
UTILITIES CORPORATION

90 MAR 20 AM 11:43

DELAWARE P.S.C.

March 17, 1998

Mr. Bruce H. Burcat  
Executive Director  
Delaware Public Service Commission  
861 Silver Lake Boulevard  
Suite 100  
Dover, DE 19904

Re: Chesapeake Utilities Corporation ("Chesapeake")  
Application for Approval to Issue Common Stock (P.S.C. Docket No. 98-86)

Dear Mr. Burcat:

Please find enclosed an original and nine copies of certain amendments to the above-mentioned Application, which was previously filed with the Delaware Public Service Commission on March 2, 1998. The amendments that we are enclosing herewith include the following:

Exhibit C  
Schedule No. 1  
Schedule No. 2  
Schedule No. 3

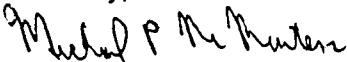
In addition, part "5" of the Application should now read as follows:

Subject to the terms and conditions set forth in the Merger Agreement, Chesapeake proposes to issue to the shareholders of SSWC 25,000 shares of Chesapeake common stock. Contemporaneously with the purchase of the stock of SSWC by Chesapeake's subsidiary, CPK Sub-B, CPK Sub-B and SSWC intend to merge, with SSWC being the surviving entity.

These amendments reflect a change in the number of shares of Chesapeake stock to be issued in the transaction from 33,000 to 25,000. The original Application included one piece of property which is no longer part of the transaction, thereby resulting in a decrease of 8,000 shares to be issued. Excluding the change in the number of shares, the draft Merger Agreement that was included as part of the original Application has not substantially changed.

If you have any questions with respect to the above or the amendments attached hereto, please do not hesitate to call either Beth Cooper at (302) 734-6015 or myself at (302) 734-6798.

Sincerely,



Michael P. McMasters  
Vice President, Treasurer & CFO

cc: William A. Denman

Chesapeake Utilities Corporation

909 Silver Lake Boulevard • Dover, Delaware 19904 • 302.734.6799 • 302.734.6750 / fax

Consolidated Balance Sheet

As of September 30, 1997

Page 1 of 4

UNAUDITED

	ACTUAL BEFORE ISSUANCE	ADJUSTMENT	PRO FORMA BEFORE ISSUANCE	ISSUANCE OF COMMON STOCK	PRO FORMA AFTER ISSUANCE OF EQUITY
<b>ASSETS</b>					
<b>PROPERTY, PLANT AND EQUIPMENT</b>					
At original cost	\$140,954,367		\$140,954,367	\$750,746	\$141,705,113
Less: Accum. depreciation and amortization	(42,800,914)		(42,800,914)	(420,957)	(43,221,871)
Net property, plant and equipment	98,153,453	0	98,153,453	329,789	98,483,242
<b>INVESTMENTS</b>	2,340,007	0	2,340,007	0	2,340,007
<b>CURRENT ASSETS</b>					
Cash and cash equivalents	1,467,700		1,467,700	44,516	1,512,216
Accounts receivable, net	7,357,140		7,357,140	87,159	7,444,299
Materials and supplies	1,684,040		1,684,040	47,661	1,731,701
Propane inventory	2,426,356		2,426,356	0	2,426,356
Storage gas prepayments	4,005,715		4,005,715	0	4,005,715
Other prepaid expenses	750,720		750,720	7,268	757,988
Deferred income taxes	813,681		813,681	0	813,681
Underrecovered purchased gas costs	203,556		203,556	0	203,556
Total current assets	18,708,908	0	18,708,908	186,604	18,895,512
<b>DEFERRED CHARGES</b>					
Environmental regulatory assets	6,501,505		6,501,505	0	6,501,505
Environmental expenditures, net	2,262,938		2,262,938	0	2,262,938
Order 636 Transition cost	0		0	0	0
Other deferred charges & intangible assets	3,853,401		3,853,401	264,084	4,117,485
Total deferred charges & other assets	12,617,844	0	12,617,844	264,084	12,881,928
<b>TOTAL ASSETS</b>	<u>\$131,820,212</u>	<u>\$0</u>	<u>\$131,820,212</u>	<u>\$780,477</u>	<u>\$132,600,689</u>

UNAUDITED

LIABILITIES AND CAPITALIZATION	ACTUAL BEFORE ISSUANCE	ADJUSTMENT	PRO FORMA BEFORE ISSUANCE	ISSUANCE OF COMMON STOCK	PRO FORMA AFTER ISSUANCE OF EQUITY
<b>CAPITALIZATION</b>					
Common stock	\$2,181,014		\$2,181,014	\$12,168	\$2,193,182
Additional paid-in capital	19,433,279		19,433,279	38,833	19,472,112
Retained earnings	26,947,738		26,947,738	144,536	27,092,274
Less: Unearned compensation	(234,348)		(234,348)	0	(234,348)
Net unrealized gain on mkt. securities	64,560		64,560	0	64,560
Total stockholders' equity	48,392,243	0	48,392,243	195,536	48,587,779
<b>LONG-TERM DEBT, NET OF CURRENT</b>	28,642,000	10,000,000	38,642,000	0	38,642,000
<b>TOTAL CAPITALIZATION</b>	77,034,243	10,000,000	87,034,243	195,536	87,229,779
<b>CURRENT LIABILITIES</b>					
Current portion of long-term debt	659,868		659,868	0	659,868
Short-term borrowings	18,400,000	(10,000,000)	8,400,000	489,076	8,889,076
Accounts payable	6,348,741		6,348,741	80,633	6,429,374
Refunds payable to customers	336,575		336,575	0	336,575
Accrued interest	619,444		619,444	0	619,444
Overrecovered purchased gas costs	0		0	0	0
Dividends payable	1,086,650		1,086,650	0	1,086,650
Income taxes payable	216,574		216,574	0	216,574
Other accrued expenses	3,862,271		3,862,271	15,232	3,877,503
Total current liabilities	31,530,123	(10,000,000)	21,530,123	584,941	22,115,064
<b>DEFERRED CREDITS</b>					
Deferred income taxes	10,230,179		10,230,179	0	10,230,179
Deferred investment tax credits	840,201		840,201	0	840,201
Environmental liability	6,501,505		6,501,505	0	6,501,505
Accrued pension costs	2,230,258		2,230,258	0	2,230,258
Order 636 transition liability	0		0	0	0
Other liabilities	3,453,703		3,453,703	0	3,453,703
Total deferred credits and other liabilities	23,255,846	0	23,255,846	0	23,255,846
<b>TOTAL LIABILITIES AND CAPITALIZATION</b>	<u>\$131,820,212</u>	<u>\$0</u>	<u>\$131,820,212</u>	<u>\$780,477</u>	<u>\$132,600,689</u>

CHESAPEAKE UTILITIES CORPORATION  
Annualized Consolidated Income Statement  
For the Twelve Months Ended September 30, 1997

REV. D  
EXHIBIT C  
Page 3 of 4

UNAUDITED

	ACTUAL BEFORE ISSUANCE	ADJUSTMENT	PRO FORMA BEFORE ISSUANCE	ISSUANCE OF COMMON STOCK	PRO FORMA AFTER ISSUANCE OF EQUITY
OPERATING REVENUES	\$124,669,424	\$0	\$124,669,424	\$1,539,638	\$126,209,062
OPERATING EXPENSES					
Purchased gas costs	75,630,932		75,630,932	0	75,630,932
Operations	26,404,834		26,404,834	1,223,093	27,627,927
Maintenance	2,216,559		2,216,559	73,643	2,290,202
Depreciation and amortization	5,353,076		5,353,076	61,496	5,414,572
Taxes-other than income	3,824,831		3,824,831	58,059	3,882,890
Taxes-income	3,186,411		3,186,411	38,331	3,224,742
Total Operating Expenses	116,616,643	0	116,616,643	1,454,622	118,071,265
NET OPERATING INCOME	8,052,781	0	8,052,781	85,016	8,137,797
OTHER INCOME AND DEDUCTIONS	377,347	0	377,347	1,290	378,637
INCOME BEFORE INTEREST CHARGES	8,430,128	0	8,430,128	86,306	8,516,434
INTEREST CHARGES					
Interest - Long-Term Debt	2,339,859	685,000	3,024,859	0	3,024,859
Interest - Short Term Borrowings	623,776	(562,680)	61,096	27,519	88,615
Interest - Other	247,838		247,838	0	247,838
Amortization of Debt Expense	115,632		115,632	0	115,632
Capital Leases	0		0	0	0
AFUDC	(82,964)		(82,964)	0	(82,964)
Total Interest Charges	3,244,141	122,320	3,366,461	27,519	3,393,980
TOTAL NET INCOME	\$5,185,987	(\$122,320)	\$5,063,667	\$58,787	\$5,122,454

The following adjustments have been made to the Income Statement and Balance Sheet for September 30, 1997:

- (1) The results as of September 30, 1997 have been adjusted to reflect the 6.85%, \$10 million long-term debt financing consummated on December 15, 1997 by Chesapeake.
- (2) A reclass was made between Common stock and Additional paid-in capital for SSWC so that the Common stock number would represent 25,000 shares of Chesapeake stock at a par value of \$.4867.
- (3) All notes payable, mortgages payable, and loans payable of SSWC would be paid off by Chesapeake at closing. Chesapeake would increase its short-term borrowings to pay off these items.
- (4) Interest expense was recalculated using Chesapeake's average short-term borrowing interest rate for 1997, which was 5.6268%. An adjustment was made to both long-term and short-term interest as a result of the \$10 million financing on December 15, 1997. Interest was also recalculated on the SSWC indebtedness that will be paid off by Chesapeake at closing.
- (5) SSWC does not record income taxes each month, but rather waits until the end of the respective fiscal year, August 31. Income taxes for a full year were calculated at 40%.



UNAUDITED

	ACTUAL BEFORE ISSUANCE			PRO FORMA BEFORE ISSUANCE			PRO FORMA AFTER ISSUANCE OF EQUITY	
TYPE OF CAPITAL	AMOUNT OUTSTANDING	% OF TOTAL	ADJUSTMENT	AMOUNT OUTSTANDING	% OF TOTAL	ISSUANCE OF COMMON STOCK	AMOUNT OUTSTANDING	% OF TOTAL
COMMON EQUITY								
COMMON STOCK	\$2,181,014	2.27%	\$0	\$2,181,014	2.27%	\$12,168	\$2,193,182	2.27%
PAID IN CAPITAL	19,433,279	20.22%	0	19,433,279	20.22%	38,833	19,472,112	20.12%
RETAINED EARNINGS	26,777,950	27.87%	0	26,777,950	27.87%	144,536	26,922,486	27.82%
TOTAL COMMON EQUITY	48,392,243	50.36%	0	48,392,243	50.36%	195,536	48,587,779	50.21%
PREFERRED STOCK	0	0.00%	0	0	0.00%	0	0	0.00%
LONG-TERM DEBT								
FIRST MORTGAGE BONDS	4,560,000	4.75%	0	4,560,000	4.75%	0	4,560,000	4.71%
CONVERTIBLE DEBENTURES	4,082,000	4.25%	0	4,082,000	4.25%	0	4,082,000	4.22%
OTHER LONG-TERM DEBT	20,000,000	20.81%	10,000,000	30,000,000	31.22%	0	30,000,000	31.00%
TOTAL LONG-TERM DEBT	28,642,000	29.81%	10,000,000	38,642,000	40.22%	0	38,642,000	39.93%
TOTAL PERMANENT CAPITAL	77,034,243	80.17%	10,000,000	87,034,243	90.58%	195,536	87,229,779	90.14%
CURRENT PORTION OF LTD	659,868	0.69%	0	659,868	0.69%	0	659,868	0.68%
SHORT-TERM DEBT	18,400,000	19.14%	(10,000,000)	8,400,000	8.73%	489,076	8,889,076	9.18%
TOTAL CAPITALIZATION	\$96,094,111	100.00%	\$0	\$96,094,111	100.00%	\$684,612	\$96,778,723	100.00%

CHESAPEAKE UTILITIES CORPORATION  
Schedule No. 2  
Rate of Return, Actual Annualized and Pro Forma  
For the Twelve Months Ended September 30, 1997

UNAUDITED

	ACTUAL BEFORE ISSUANCE	ADJUSTMENT	PRO FORMA BEFORE ISSUANCE	ISSUANCE OF COMMON STOCK	PRO FORMA AFTER ISSUANCE OF EQUITY
<u>Statement of Income</u>					
1 Operating revenues	\$124,669,424	\$0	\$124,669,424	\$1,539,638	\$126,209,062
2 Operating expenses before income taxes	\$113,430,232	\$0	\$113,430,232	\$1,416,291	\$114,846,523
3 Income taxes (Including Deferrals)	\$3,186,411	\$0	\$3,186,411	\$38,331	\$3,224,742
4 Operating Income (1-(2+3))	\$8,052,781	\$0	\$8,052,781	\$85,016	\$8,137,797
5 AFUDC (Equity Only)	\$101,384	\$0	\$101,384	\$0	\$101,384
6 Other Income, Net	\$275,963	\$0	\$275,963	\$1,290	\$277,253
7 Income Before Interest Charges (4+5+6)	\$8,430,128	\$0	\$8,430,128	\$86,306	\$8,516,434
8 Interest Charges (Including debt portion of AFUDC)	\$3,244,141	\$122,320	\$3,366,461	\$27,519	\$3,393,980
9 Net Income From Continuing Operations (7-8)	\$5,185,987	(\$122,320)	\$5,063,667	\$58,787	\$5,122,454
10 Preferred stock dividends	\$0	\$0	\$0	\$0	\$0
11 Earnings available to common equity (9-10)	\$5,185,987	(\$122,320)	\$5,063,667	\$58,787	\$5,122,454
12 Average capitalization	\$77,698,787	\$10,000,000	\$87,698,787	\$195,536	\$87,894,323
13 Average common equity	\$48,455,505	\$0	\$48,455,505	\$195,536	\$48,651,041
14 Return on average capitalization (7/12)	10.85%		9.61%		9.69%
15 Return on average common equity (11/13)	10.70%		10.45%		10.53%

## UNAUDITED

<u>Type of Method</u>	<u>HISTORICAL</u>		<u>ANNUALIZED</u>	
	<u>ACTUAL BEFORE ISSUANCE</u>	<u>PRO FORMA AFTER ISSUANCE OF EQUITY</u>	<u>PRO FORMA BEFORE ISSUANCE</u>	<u>PRO FORMA AFTER ISSUANCE OF EQUITY</u>
<u>Per Financial Statements</u>				
Before Income Taxes, all interest	3.4323	3.4273	3.3482	3.3230
Before Income Taxes, all interest, before AFUDC	3.4026	3.3979	3.3195	3.2946
After Income Taxes, all interest	1.5187	1.5216	1.4662	1.4371
After Income Taxes, all interest, before AFUDC	1.4890	1.4923	1.4376	1.4086
Overall Coverage, (after income taxes)	1.5187	1.5216	1.4662	1.4371
Overall Coverage, (after income taxes) before AFUDC	1.4890	1.4923	1.4376	1.4086
<u>Modified Indenture Method</u>				
Before Income Taxes, all interest	3.9611	3.9480	3.8039	3.8103
Before Income Taxes, all interest, before AFUDC	3.9269	3.9142	3.7710	3.7777
After Income Taxes, all interest	1.8451	1.8439	1.7322	1.7358
After Income Taxes, all interest, before AFUDC	1.8109	1.8101	1.6993	1.7032
Overall Coverage, (after income taxes)	1.8451	1.8439	1.7322	1.7358
Overall Coverage, (after income taxes) before AFUDC	1.8109	1.8101	1.6993	1.7032

March 2, 1998

Mr. Bruce H. Burcat  
Executive Director  
Delaware Public Service Commission  
861 Silver Lake Boulevard  
Suite 100  
Dover, DE 19904

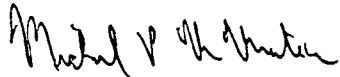
Re: **Chesapeake Utilities Corporation ("Chesapeake")**  
**Application for Approval to Issue Common Stock**

Dear Mr. Burcat:

Please find enclosed an original and nine copies of the above mentioned application for approval of the issuance of 33,000 shares of Chesapeake Utilities Corporation common stock for the purpose of acquiring all of the outstanding common stock of Sam Shannahan Well Company, Inc., d/b/a Tolan Water Service.

If you have any questions with respect to the above, please do not hesitate to call me at (302) 734-6798.

Sincerely,



Michael P. McMasters  
Vice President, Treasurer & CFO

cc: William A. Denman

BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF DELAWARE

IN THE MATTER OF THE APPLICATION OF  
CHESAPEAKE UTILITIES CORPORATION  
FOR APPROVAL OF THE ISSUANCE OF  
COMMON STOCK

\* P.S.C. Docket No. 98-86  
\*  
\*  
\* APPLICATION

Chesapeake Utilities Corporation (hereinafter sometimes called "Chesapeake") pursuant to 26 Del. C. section 215, makes the following application for approval by the Commission of the issuance of 33,000 shares of Chesapeake common stock.

1. Chesapeake is a Delaware public utility with its principal place of business located at 909 Silver Lake Boulevard, Dover, Delaware 19904. All communications should be addressed to Chesapeake at the foregoing address, attention: Michael P. McMasters, Vice President, Treasurer and Chief Financial Officer, or Beth W. Cooper, Assistant Treasurer.

2. Counsel for the applicant is William A. Denman, 414 South State Street, P.O. Box 497, Dover, Delaware 19903. Correspondence and other communications concerning this application should be directed to counsel at the foregoing address.

3. Chesapeake is a corporation incorporated under the laws of the State of Delaware. The voting stock of Chesapeake is publicly owned. Shares of common stock, 4,504,079 of which were outstanding as of December 31, 1997, are the only voting securities of Chesapeake. Each share is entitled to one vote.

4. Sam Shannahan Well Company, Inc., d/b/a Tolan Water Service, ("SSWC") is a family-owned company located in Salisbury, Maryland, specializing in residential,

commercial and industrial water treatment systems and irrigation. Subject to the terms and conditions set forth therein, by agreement and plan of merger, Chesapeake, through a subsidiary of Chesapeake formed for the purpose of effecting said transaction, CPK Sub-B, has agreed to purchase all of the outstanding common stock of SSWC. A draft of the proposed Agreement and Plan of Merger (the "Merger Agreement") is attached hereto as Exhibit "A" and incorporated herein by reference.

5. Subject to the terms and conditions set forth in the Merger Agreement, Chesapeake proposes to issue to the shareholders of SSWC 33,000 shares of Chesapeake common stock. Contemporaneously with the purchase of the stock of SSWC by Chesapeake's subsidiary, CPK Sub-B, CPK Sub-B and SSWC intend to merge, with SSWC being the surviving entity.

6. The shares of Chesapeake common stock to be issued pursuant to the Merger Agreement will be issued as restricted securities, as defined in Rule 144 under the Securities Act of 1933.

7. At the time the Merger Agreement is consummated, Chesapeake will simultaneously pay off the notes, loans and mortgages payable of SSWC. In so doing, Chesapeake's short-term borrowings will likewise increase.

8. The issuance of Chesapeake's stock for the outstanding common stock of SSWC is advantageous to Chesapeake because it expands Chesapeake's presence on the Delmarva Peninsula.

9. The reason for the selection of the type and amount of proposed new securities is to provide for a tax free exchange for the shareholders of SSWC and to be able to account for the acquisition under the pooling of interests method of accounting.

10. The Board of Directors of Chesapeake approved the aforesaid issuance of common stock on the 19th day of January 1998.

11. A copy of the opinion of counsel for Chesapeake with respect to the legality of the proposed issuance of common stock is attached hereto as Exhibit "B".

12. Attached hereto as Exhibit "C" and incorporated herein by reference is a schedule setting forth Chesapeake's balance sheet and income statement for the twelve months ended September 30, 1997 both before and after the issuance of the common stock.

13. Attached hereto as Exhibit "D" is a copy of Chesapeake's annual report on Form 10-K for the calendar year ending December 31, 1996. Attached hereto as Exhibit "E" is Chesapeake's most recent quarterly report on Form 10-Q. Both reports have been filed with the Securities and Exchange Commission.

14. Pursuant to the Commission's minimum filing requirements - Part (D), attached hereto and incorporated herein by reference are the following schedules:

A. Schedule No. 1 - Capitalization ratios, actual and pro forma, as of September 30, 1997.

B. Schedule No. 2 - Rate of return, actual, pro forma and annualized for the twelve months ended September 30, 1997.

C. Schedule No. 3 - Fixed charge coverage ratios, historical and annualized, for the twelve months ended September 30, 1997.

15. Chesapeake represents that the proposed issuance of common stock is in accordance with law, for a proper purpose, and consistent with the public interest.

WHEREFORE, Chesapeake prays as follows:

A. That the Commission file this application and make such investigation and hold such hearings in the matter as it deems necessary;

B. That the Commission approve the proposed issuance of common stock by Chesapeake as described herein.

CHESAPEAKE UTILITIES CORPORATION

By: Michael P. McMasters  
Michael P. McMasters  
Vice President, Treasurer & CFO

SCHMITTINGER & RODRIGUEZ, P.A.

By: William A. Denman  
WILLIAM A. DENMAN, ESQUIRE  
P.O. Box 497  
Dover, DE 19903

DATED: March 2, 1998



STATE OF DELAWARE   \*  
                                  \*       SS.  
COUNTY OF KENT       \*

BE IT REMEMBERED that on this 2nd day of March, A.D., 1998, personally appeared before me, a Notary Public for the State of Delaware, MICHAEL P. McMASTERS, who being by me duly sworn, did depose and say that he is the Vice President, Treasurer & CFO of Chesapeake Utilities Corporation, a Delaware corporation, and that insofar as the Application of Chesapeake Utilities Corporation states facts and insofar as those facts are within his personal knowledge, they are true; and insofar as those facts are not within his personal knowledge, he believes them to be true; and that the exhibits accompanying this Application and attached hereto are true and correct copies of the originals of the aforesaid exhibits; and that he has executed this Application on behalf of the Company and pursuant to the authorization of its Board of Directors.

  
\_\_\_\_\_  
MICHAEL P. McMASTERS  
Vice President, Treasurer & CFO

SWORN TO AND SUBSCRIBED before me that day and year first above written.

  
\_\_\_\_\_  
NOTARY PUBLIC

My Commission Expires: October 21, 2001

APPLICATION OF CHESAPEAKE UTILITIES CORPORATION  
FOR APPROVAL OF THE ISSUANCE OF STOCK

TABLE OF CONTENTS

EXHIBIT A	- Draft Agreement and Plan of Merger between Chesapeake Utilities Corporation and Sam Shannahan Well Company, Inc.
EXHIBIT B	- Opinion of Legal Counsel
EXHIBIT C	- Balance Sheet and Income Statement for Chesapeake Utilities Corporation for the Twelve Months Ended September 30, 1997
EXHIBIT D	- 1996 Annual Report on Form 10-K
EXHIBIT E	- September 30, 1997 Quarterly Report on Form 10Q
SCHEDULE NO. 1	- Capitalization Ratios - Actual and Pro Forma as of September 30, 1997
SCHEDULE NO. 2	- Rate of Return - Actual, Pro Forma and Annualized for the Twelve Months Ended September 30, 1997
SCHEDULE NO. 3	- Fixed Charge Coverage Ratios - Historical and Annualized for the Twelve Months Ended September 30, 1997

**DRAFT**

Exhibit A

**AGREEMENT AND PLAN OF MERGER**

THIS AGREEMENT AND PLAN OF MERGER (the "Agreement") is made and entered into this \_\_\_\_ day of \_\_\_\_\_, 1998, by and among Chesapeake Utilities Corporation, a Delaware corporation ("Chesapeake"), CPK Sub-B, Inc., a Delaware corporation ("CPK Sub-B"), Sam Shannahan Well Company, Inc., d/b/a Tolan Water Service, a Maryland corporation ("SSWC"), and Dashiell J. (Duke) Shannahan, and Joyce C. Shannahan, residents of Maryland (each, a "Shareholder" and collectively, the "Shareholders").

**ARTICLE I  
THE MERGER**

**SECTION 1.1 The Merger.** Upon the terms and subject to the conditions hereof, as promptly as practicable following the satisfaction or waiver of the conditions set forth in Article VIII hereof, but in no event later than two business days thereafter, unless the parties hereto shall otherwise agree, articles of merger (the "Articles of Merger") providing for the merger of CPK Sub-B with and into SSWC (the "Merger") shall be duly prepared, executed and filed by SSWC, as the surviving corporation (the "Surviving Corporation"), in accordance with the relevant provisions of the Maryland General Corporation Law (the "MGCL") and the Merger shall become effective. Following the Merger, the Surviving Corporation shall continue under the same name as SSWC and the separate corporate existence of CPK Sub-B shall cease. The date and time the Merger becomes effective is referred to herein as the "Effective Time." Immediately prior to the filing of the Articles of Merger, a closing (the "Closing") shall take place at the offices of Laws & Laws, P.A., 209 East Main Street, Salisbury, Maryland 21801, or such other place and time as the parties shall agree.

**SECTION 1.2 Effects of the Merger.** The Merger shall have the effects set forth in Section 3-114 of the MGCL.

**SECTION 1.3 Articles of Incorporation and By-Laws.** The Articles of Incorporation of SSWC and the By-laws of CPK Sub-B (both of which have been heretofore delivered by SSWC to Chesapeake or Chesapeake to SSWC, as the case may be), in each case as in effect immediately prior to the Effective Time, shall be the Articles of Incorporation and By-laws of the Surviving Corporation until duly amended in accordance with applicable law.

**SECTION 1.4 Directors.** The directors of CPK Sub-B immediately prior to the Effective Time shall be the initial directors of the Surviving Corporation and shall hold office until their respective successors are duly elected and qualified in accordance with the Articles of Incorporation and By-laws of the Surviving Corporation, or their earlier death, resignation or removal.

SECTION 1.5 Officers. The officers of CPK Sub-B immediately prior to the Effective Time shall be the initial officers of the Surviving Corporation and shall serve as the officers of the Surviving Corporation at the pleasure of the Board of Directors of the Surviving Corporation.

SECTION 1.6 Conversion of Shares. At the Effective Time, by virtue of the Merger and without any action on the part of the holders thereof:

(a) Subject to Section 2.2, each issued and outstanding shares of common stock, par value \$10.00 per share, of SSWC (the "SSWC Common Stock") shall automatically be converted into the right to receive (the "Merger Consideration") that amount of fully paid and nonassessable shares of common stock, par value \$.4867 per share, of Chesapeake (the "Chesapeake Common Stock"), which shall be determined by dividing 33,000 by the aggregate number of outstanding shares of SSWC Common Stock at the Effective Time (the "Exchange Ratio"), provided that in the event of a stock split or reverse stock split in either the SSWC Common Stock or the Chesapeake Common Stock prior to the Effective Time, the Exchange Ratio shall be adjusted proportionately in order to prevent either dilution or enlargement of the rights of the Shareholders.

(b) Each share of capital stock of SSWC that is held in the treasury of SSWC shall be canceled and retired and cease to exist and no consideration shall be issued in exchange therefor.

(c) The issued and outstanding shares of capital stock of CPK Sub-B shall be converted into and become, in the aggregate, 1000 fully paid and nonassessable shares of common stock of the Surviving Corporation.

## ARTICLE II EXCHANGE OF SHARES

SECTION 2.1 Surrender of Certificates. At the Effective Time, each of the Shareholders shall surrender the certificate or certificates that formerly represented that Seller's shares of SSWC Common Stock to the Surviving Corporation, and shall thereupon receive in exchange therefor the Merger Consideration for each share of SSWC Common Stock formerly represented by such certificate or certificates, and the certificates so surrendered shall forthwith be cancelled.

SECTION 2.2 No Fractional Shares. No certificate or scrip representing fractional shares of Chesapeake Common Stock shall be issued upon the surrender for exchange of certificates of SSWC Common Stock, and such fractional share interests will not entitle the owner thereof to vote or to any rights of a stockholder of Chesapeake. In lieu of any such fractional share interest, Chesapeake shall issue to Shareholders jointly, as tenants by the entireties, any share which would otherwise be required or be divided into fractional shares by applying the Exchange Ratio to the Shareholders' separate

respective shares of the SSWC Common Stock as provided in Section 1.6(a) of this Agreement.

ARTICLE III  
REPRESENTATIONS AND WARRANTIES  
OF SSWC AND SHAREHOLDERS

SSWC and each of the Shareholders, severally and not jointly, represents and warrants to Chesapeake and CPK Sub-B as follows:

SECTION 3.1 Corporate Organization.

(a) SSWC is a corporation duly organized, validly existing and in good standing under the laws of Maryland and has all requisite corporate power and authority to own, lease and operate its properties and to carry on its business as now being conducted. SSWC is currently qualified and properly licensed to do business in and is in good standing in each of these states: Delaware, Maryland and Virginia. SSWC has heretofore delivered to Chesapeake accurate and complete copies of its Articles of Incorporation and By-laws, as in effect on the date of this Agreement.

(b) SSWC does not own, directly or indirectly, any capital stock or other equity securities or similar interest in any corporation, partnership, joint venture, or other business association or entity.

(c) Since at least December 31, 1995, SSWC has never been a subsidiary of another organization or had any other corporation, partnership, joint venture, or other business association or entity own or hold any of its capital stock, equity securities or similar interest.

SECTION 3.2 Capitalization.

(a) The authorized capital stock of SSWC consists of \_\_\_\_\_ shares of SSWC Common Stock, of which 5100 shares are issued and outstanding. Shareholder Dashiell J. Shannahan owns 2,600 shares and Shareholder Joyce C. Shannahan owns 2,500 shares. All of the issued and outstanding shares of SSWC Common Stock are validly issued, fully paid and nonassessable. As of the date of this Agreement, no shares of SSWC Common Stock were issuable upon exercise of stock options or warrants or conversion of any preferred stock or debt security or instrument. There are not as of the date of this Agreement, and at the Effective Time there will not be, any shares of capital stock (or securities substantially equivalent to capital stock) of SSWC issued or outstanding or any subscriptions, options, warrants, calls, rights, convertible securities or other agreements or commitments of any character obligating SSWC to issue, transfer or sell any of its securities or outstanding shares of SSWC Common Stock.

(b) There has been no change in the equity ownership of SSWC, since, at the latest, December 31, 1995.

**SECTION 3.3 Authority Relative to this Agreement: Binding Effect.**

(a) SSWC has full corporate power and authority to execute and deliver this Agreement and to consummate the transactions contemplated hereby. The execution and delivery of this Agreement and the consummation of the transactions contemplated hereby have been duly and validly authorized and approved by the Board of Directors of SSWC and by the unanimous vote or written consent of the stockholders of SSWC and no other corporate proceedings on the part of SSWC are necessary to authorize this Agreement or to consummate the transactions so contemplated. This Agreement has been duly and validly executed and delivered by SSWC and constitutes a legal, valid and binding agreement of SSWC, enforceable against SSWC in accordance with its terms.

(b) This Agreement has been duly and validly executed and delivered by each Seller and constitutes a legal, valid and binding agreement of each Seller, enforceable against each Seller in accordance with its terms.

**SECTION 3.4 Consents and Approvals; No Violations.** Except for the filing and recordation of the Articles of Merger, as required by the MGCL, no filing with or notification to, and no permit, authorization, consent, waiver or approval of, any government, executive official thereof, governmental or regulatory authority, agency or commission, including courts of competent jurisdiction, domestic or foreign (a "Governmental Entity"), is necessary for the consummation by SSWC and the Shareholders of the transactions contemplated by this Agreement, excluding, however, filings, permits, authorizations, consents, or approvals of any kind required by the Federal Energy Regulatory Commission ("FERC") or the Public Utility Commission or similar utility regulatory body of the States of Florida, Maryland or Delaware. Neither the execution and delivery of this Agreement by SSWC and the Shareholders nor the consummation by SSWC and the Shareholders of the transactions contemplated hereby nor compliance by SSWC and the Shareholders with any of the provisions hereof will (i) conflict with or result in any breach of any provision of the Articles of Incorporation or By-laws of SSWC, (ii) result in a violation or breach of, or constitute (with or without due notice or lapse of time or both) a default (or give rise to any right of termination, cancellation or acceleration or result in the creation of any mortgage, pledge, charge, security interest, claim or encumbrance of any kind (collectively, a "Lien") under, any of the terms conditions or provisions of any note, bond, mortgage, indenture, license, contract, agreement or other instrument or obligation to which SSWC or a Shareholder is a party or by which they or any of their properties or assets may be bound, or (iii) violate any order, writ, injunction, decree, or statute applicable to SSWC or a Shareholders or any of their properties or assets, or (iv) result in a violation of any rule or regulation applicable to SSWC or a Shareholder or any of their properties or assets.

SECTION 3.5 Absence of Certain Changes. Since November 30, 1997 SSWC has not:

(a) suffered any Material Adverse Change; "Material Adverse Change" means (i) any material change in the nature of SSWC, business, assets, financial condition, results of operations, or prospects, (ii) the loss of a contract which contributed in excess of twenty thousand dollars (\$20,000.00) of revenues to SSWC in fiscal year 1997, and (iii) any change that creates a material limitation on the ability to conduct the business of SSWC as heretofore conducted;

(b) paid, discharged or otherwise satisfied any material claims, liabilities or obligations (absolute, accrued, contingent or otherwise) other than the payment, discharge or satisfaction in the ordinary course of business and consistent with past practice;

(c) permitted or allowed any of its material property or assets (real, or mixed, tangible or intangible) to be subjected to any Liens, except for: (i) Liens for current taxes or other governmental charges not yet due and payable, or the validity of which is being contested by appropriate proceedings and for which an appropriate reserve has been established; (ii) Liens of carriers, warehousemen, mechanics and materialmen and similar Liens incurred in the ordinary course of business; and (iii) zoning and other land use regulations (collectively, "Permitted Liens");

(d) sold, transferred, or otherwise disposed of any of its properties or assets (real, personal or mixed, tangible or intangible), except in the ordinary course of business and consistent with past practice;

(e) granted any increase in the compensation or benefits of any officer or employee (including any such increase pursuant to any bonus, pension, profit sharing or other plan or commitment) or any increase in the compensation or benefits payable or to become payable to any officer or employee, and no such increase is customary on a periodic basis or required by agreement or understanding;

(f) made any change in severance policy or practices;

(g) made any expenditure capitalized in accordance with SSWC's current accounting policies or acquired any property or assets (other than new materials and supplies) for a cost in excess of \$20,000, in the aggregate, excluding from this aggregate amount expenditures in the ordinary course of business on water treatment supplies and equipment and new vehicles, the purchase of which has been previously disclosed to Chesapeake;

(h) declared, paid or set aside for payment any dividend or other distribution in respect of its capital stock or redeemed, purchased or otherwise acquired, directly or indirectly, any shares of capital stock or other securities of SSWC;

(i) made any material change in any method of tax or financial accounting or accounting practice or made or changed any election for Federal income tax purposes without the consent of Chesapeake;

(j) paid, loaned or advanced any amount to, or sold, transferred or leased any properties or assets (real, personal or mixed, tangible or intangible) to, or entered into any agreement or arrangement with, any of its officers, directors or stockholders or any affiliate or associate of any of its officers, directors or stockholders; or

(k) agreed or planned, whether in writing or otherwise, to take any action described in this Section.

**SECTION 3.6 Unaudited Financial Statements.** SSWC shall have furnished to Chesapeake prior to the date of this Agreement an unaudited balance sheet of SSWC as of November 30, 1997 and an unaudited statement of operations for the three month period ending November 30, 1997 (collectively, the "Unaudited Financial Statements"). The Unaudited Financial Statements are attached to this Agreement and made a part hereof as Exhibit 1. Such Unaudited Financial Statements shall be certified by the Chief Executive Officer of SSWC as having been prepared under his supervision; to be true, correct and complete in all material respects; and to reflect accurately the books and records of SSWC, in all material respects, subject to normal year-end adjustments.

**SECTION 3.7 No Undisclosed Liabilities.** Except as and to the extent provided in the Unaudited Financial Statements, since November 30, 1997, SSWC has not incurred any liability except in the ordinary course of business consistent with past practice.

**SECTION 3.8 No Default.** SSWC is not in default or violation (and no event has occurred that with notice or the lapse of time or both would constitute a default or violation) of any term, condition or provision of (i) its Articles of Incorporation or its By-laws, (ii) any note, bond, mortgage, indenture, license, contract, agreement or other instrument or obligation to which SSWC is a party or by which it or any of its properties or assets may be bound (unless, in the case of a contract, such default would not have a material adverse effect on SSWC), or (iii) any order, written injunction, decree, statute, rule or regulation applicable to SSWC or any of its properties or assets, unless such default or violation will not have a material adverse effect on SSWC.

**SECTION 3.9 Litigation.** There is no action, suit, proceeding, arbitration, or investigation pending or threatened by or before any Governmental Entity involving SSWC or any of its properties or assets. Neither SSWC nor any of its properties or assets is subject to any order, writ, judgment, injunction, decree, determination or award. There is no action, suit, proceeding, arbitration or investigation initiated by SSWC currently pending or that SSWC presently intends to initiate.



### SECTION 3.10 Compliance with Applicable Law.

(a) The business of SSWC has not been conducted in violation of any applicable law, ordinance, rule, regulation, decree or order of any Governmental Entity. SSWC holds all permits, licenses, variances, exemptions, orders and approvals of all Governmental Entities necessary for the lawful conduct of its businesses (the "SSWC Permits") and is in compliance with the terms of the SSWC Permits. Neither SSWC nor either Shareholder has received any notification of any asserted present or past failure by SSWC to comply with such laws, rules or regulations or such SSWC Permits, or any such asserted failures have been previously cured, and to the knowledge of SSWC, there is no pending audit, investigation or other review by any Governmental Entity to determine the existence of any violation of such laws, rules or regulations or such SSWC Permits.

(b) For purposes of this Agreement, "knowledge of SSWC" or "known by SSWC" shall include knowledge of either SSWC or either of the Shareholders.

### SECTION 3.11 Taxes.

(a) Since \_\_\_\_\_, SSWC has been a C corporation as defined by the Internal Revenue Code of 1986, as amended, and the rules and regulations promulgated thereunder (the "Code").

(b) The amounts, if any, provided as a liability on the Unaudited Financial Statements for all Taxes (as hereinafter defined) are adequate to cover all unpaid liabilities for all Taxes, whether or not disputed, that have accrued or will accrue with respect to or are applicable to the period ended on and including the Effective Time (including, without limitation, as a result of the transactions contemplated by this Agreement) or to any years and periods prior thereto and for which SSWC may be directly or contingently liable in its own right or as a transferee of the assets of, or successor to, any person. SSWC has incurred no Tax liabilities other than in the ordinary course of business for any taxable year for which the applicable statute of limitations has not expired. There are no liens for Taxes (other than Liens for current Taxes not yet due and payable, or the amount or validity of which is being contested by the appropriate proceedings and for which an appropriate reserve has been established) upon the properties or assets of SSWC or of any Shareholder. SSWC has not granted or been requested to grant any waiver of any statutes of limitations applicable to any claim for Taxes. Apart from normal elections for inventory, amortization, and depreciation, SSWC has made no material elections for federal income tax purposes.

(c) SSWC (i) has filed (or has had filed on its behalf) or will file or cause to be filed timely all Tax Returns (as hereinafter defined) required by applicable law to be filed prior to or as of the Effective Time and (ii) has paid all Taxes shown thereon as owing. Each such Tax Return is true, accurate and complete. All Taxes that SSWC is required by law to withhold or collect, including sales and use taxes, and amounts required to be withheld for Taxes of employees and other withholding taxes, have been duly withheld or

collected and, to the extent required, have been paid in a timely manner to the proper governmental authorities or are held in separate bank accounts for such purpose.

(d) No extensions of time have been granted for SSWC to file any Tax Return required by applicable law to be filed prior to or as of the Effective Time, which have expired, or will expire, prior to or as of the Effective Time without such Tax Return having been filed.

(e) To the knowledge of the Shareholders, or as should be reasonably known by SSWC, none of the Tax Returns filed by or on behalf of SSWC are currently undergoing any Audit (as hereinafter defined), SSWC has received no notice that any Tax Return will undergo any Audit, and no facts exist that would constitute grounds for the assessment against SSWC of any material additional Taxes by any governmental authority for periods that have not been audited. No material issues have been raised in any Audit by any governmental authority with respect to the business and operations of SSWC that, by application of similar principles, reasonably could be expected to result in a proposed adjustment to the liability for Taxes for any other period not so examined. No deficiency or adjustment for any Taxes has been threatened, proposed, asserted, or assessed against SSWC.

(f) No power of attorney has been granted by SSWC with respect to any matter relating to Taxes which is currently in force.

(g) SSWC is not a party to any agreement providing for the allocation or sharing of Taxes.

(h) SSWC has not entered into any agreement that would result in the disallowance of any tax deduction pursuant to Code Section 280G (relating to "golden parachutes").

(i) No "consent" within the meaning of Code Section 341(f) has been filed with respect to SSWC (relating to "collapsible corporations").

(j) None of the assets of SSWC constitutes tax-exempt bond financed property or tax-exempt use property within the meaning of Code Section 168, and none of the assets reflected on the Unaudited Financial Statements is subject to a lease, safe harbor lease or other arrangement as a result of which SSWC is not treated as the owner of such assets for federal income tax purposes.

(k) To the knowledge of or as reasonably should be known by SSWC, the basis of all depreciable or amortizable assets, and the methods used in determining allowable depreciation or amortization (including cost recovery) deductions of SSWC, are materially correct and in compliance with the Code.

(l) To the knowledge of SSWC, SSWC is not required to make any material adjustment under Code Section 481(a) by reason of a change or proposed change in accounting method or otherwise.

(m) For purposes of this Agreement:

(i) the term "Taxes" shall mean all taxes, charges, fees, duties (including customs duties), levies or other assessments, including income, gross receipts, net proceeds, ad valorem, turnover, real and personal property (tangible and intangible), sales, use, franchise, excise, value added, stamp, leasing, lease, user, transfer, fuel, excess profits, occupational, interest equalization, windfall profits, severance, license, payroll, environmental, capital stock, disability, employee's income withholding, other withholding, unemployment and Social Security taxes, which are imposed by any federal, state or local governmental authority, and such term shall include any interest, penalties or additions to tax attributable thereto;

(ii) the term "Tax Return" shall include all federal, state and local tax returns, declarations, statements, reports, schedules, forms and information returns and any amended Tax Return relating to Taxes; and

(iii) the term "Audit" shall include any taxing authority's audit, assessment of Taxes or other examination proceedings or appeal of such proceedings relating to Taxes.

#### SECTION 3.12 ERISA.

(a) Except as and to the extent described in subparagraph (g) hereof, SSWC does not maintain or contribute to any "employee benefit plan," as such term is defined in the Employee Retirement Income Security Act of 1974, as amended, and the rules and regulations promulgated thereunder ("ERISA"). The employee benefits plans disclosed in subparagraph (g) hereof are referred to as the "ERISA Plans." With respect to any ERISA Plan, SSWC has provided Chesapeake with a true and complete copy of each of the following: (i) the current plan document (including all amendments) and the most recent summary plan description; (ii) the annual report on Form 5500 for the most recent year for which such report has been filed; (iii) each related trust agreement, insurance contract or investment management agreement; and (iv) the most recent Internal Revenue Service ("IRS") determination letter. Any obligation of SSWC to provide postretirement benefits or postemployment benefits under any ERISA Plan is reflected in SSWC's most recent financial statements.

(b) SSWC has complied in all material respects with all applicable provisions of ERISA and the Code and with any other laws, rules, and regulations that are applicable to the ERISA Plans, except for compliance failures that individually or in the aggregate would not have a material adverse effect on SSWC.

(c) SSWC has not offered to provide health insurance coverage to any individual, or to the family members of any individual, for any period extending beyond the termination of the individual's employment, except to the extent required by the health care continuation coverage ("COBRA") provisions in ERISA and the Code.

(d) SSWC has not at any time during the ten calendar years preceding the year of the merger maintained, or contributed to, any defined benefit plan covered by Title IV of ERISA or incurred any liability under Title IV of ERISA, and the transactions contemplated by this Agreement will not subject SSWC to any liability under Title IV of ERISA.

(e) There are no pending or, to the knowledge of SSWC, threatened claims (other than routine claims for benefits) by or on behalf of any ERISA Plan, or otherwise involving any ERISA Plan, by any participant, beneficiary, or fiduciary under such ERISA Plan.

(f) Each ERISA Plan and any other employee benefit plan maintained by SSWC can be terminated within a period of 30 days, without payment of additional compensation or amount or the additional vesting or acceleration of any benefits.

(g) Employee benefit plans, including but not limited to ERISA plans, that are maintained by SSWC as of the Effective Date, are set forth below: \_\_\_\_\_

### SECTION 3.13 Environmental Matters.

(a) Neither SSWC nor either Shareholder has learned, been advised, or received any communication (written or oral), whether from a governmental authority, citizens group, employee or otherwise, that alleges or suggests that SSWC or either Shareholders is not in full compliance with the Environmental Laws.

(b) To the knowledge of SSWC and each Shareholder, there are no Environmental Claims (as hereinafter defined) pending or threatened against SSWC or either Shareholder or against any person or entity whose liability for any Environmental Claim SSWC or either Shareholder has assumed, either contractually or by operation of law, and neither SSWC nor either Shareholder knows of any facts or allegations that could result in future Environmental Claims.

(c) To the knowledge of SSWC and each Shareholder, none of the Real Property, (as defined herein), nor any other property leased by SSWC, is on the National Priorities List or the Comprehensive Environmental Response Compensation and Liability Information System, and no such property is a Resource Conservation and Reserve Act "permitted facility." No such property is permitted by the State of Maryland to be used as a landfill or disposal site of any type.

(d) To the knowledge of SSWC and each Shareholder, and without limiting the generality of Section 3.10 of this Agreement, all applicable laws, ordinances, rules, regulations, decrees or orders of any Governmental Entity having to do with SSWC's businesses, including but not limited to water treatment, well-drilling, clean water or water composition and/or the handling, use and disposal of chemicals or chemical products or wastes, have been and are being fully complied with and adhered to.

(e) For purposes of this Agreement:

(i) "Environmental Claim" means any claims, action, cause of action, litigation, proceeding, order, decree, investigation or notice (written or oral) alleging potential liability or responsibility (including, without limitation, potential liability or responsibility for investigatory costs, cleanup costs, costs of compliance with laws, requirements, guidelines, or orders, governmental response costs, natural resources damages, property damages, personal injuries, or penalties) arising out of, based on or resulting from (a) the presence, or release into the environment, of any Material of Environmental Concern at any location, whether or not owned or operated by SSWC or (b) circumstances forming the basis of any violation, or alleged violation, of any Environmental Law.

(ii) "Environmental Laws" means all Federal, state and local laws, regulations, ordinances, rules, guidelines, orders, directives, judgments and determinations relating in any way to pollution or protection of human health or the environment (including, without limitation, ambient air, surface water, ground water, land surface or subsurface strata), including, without limitations, laws and regulations relating to emissions, discharges, releases or threatened releases of Materials of Environmental Concern, or otherwise relating to the manufacture, processing, distribution, use, treatment storage, disposal, transport or handling of Materials of Environmental Concern, as amended from time to time.

(iii) "Materials of Environmental Concern" means chemicals, pollutants, contaminants, hazardous material, hazardous substances, hazardous wastes, toxic substances, petroleum and petroleum products, and any substance controlled or regulated by any Environmental Law.

SECTION 3.14 Change in Control. SSWC is not a party to any contract, agreement or understanding which contains a "change in control," "potential change in control" or similar provision. The consummation of the transactions contemplated by this Agreement will not (either alone or upon the occurrence of any additional acts or event) result in any payment (whether of severance pay or otherwise) becoming due from SSWC to any person.

SECTION 3.15 Intellectual Property. SSWC owns, or is licensed or otherwise has the full right to use, all copyrights, trademarks and service marks (including all applications and registrations therefor), trade names, computer software, patents

(including applications therefor), and all other intellectual property that is necessary for the conduct of its business as heretofore conducted (collectively, the "Intellectual Property"), including but not limited to, a valid and subsisting franchise agreement (the "Franchise Agreement") with Ecowater, a true and complete copy of which, with any and all amendments, addenda or modifications, is attached as Exhibit 2 hereto. There are no outstanding claims, judgments, settlements or proceedings against SSWC asserting the invalidity, abuse, misuse or unenforceability of the Intellectual Property or the Franchise Agreement.

#### SECTION 3.16 Contracts and Commitments.

(a) SSWC has no agreements, contracts, commitments, or restrictions that are material to its business, prospects, financial condition, working capital, assets, liabilities (absolute, accrued, contingent or otherwise) or operations.

(b) There are no purchase contracts or commitments of SSWC, except the contracts with \_\_\_\_\_, copies of which have been previously provided to Chesapeake.

(c) There are no outstanding sales contracts or commitments of SSWC, except the contracts, copies of which have been previously provided to Chesapeake.

(d) SSWC has no outstanding contracts with officers, directors or employees that are not cancelable by it on notice of not longer than thirty (30) days and without liability, penalty, or premium, except for any agreement or arrangement providing for the payment of any bonus or commissions based on sales or earnings.

(e) SSWC is not restricted by agreement from carrying on its business anywhere in the world.

(f) SSWC's debts, obligations, and liabilities, including any guaranties or agreements to assume debts or liabilities of others, are shown on Exhibit 1. The debts, obligations, and liabilities represent the same indebtedness shown on the November 30, 1997 Unaudited Financial Statements, except for non-material changes to dollar amounts as a result of payments made or interest accrued in the ordinary course of SSWC's business since the Unaudited Financial Statements were prepared.

SECTION 3.17 Labor Relations. As of the date hereof, there is no strike or other labor dispute pending against SSWC. SSWC is not bound by or subject to (and none of its properties or assets is bound by or subject to) any written or oral, express or implied, contract, commitment or arrangement with any labor union, and no labor union has requested or sought to represent any of the employees, representative or agents of SSWC, nor is SSWC aware of any labor organization activity involving its employees.

SECTION 3.18 Employee Benefit Plans. SSWC has previously given to Chesapeake true and correct copies of its manuals, work rules, policies or other guidelines relating to employee compensation, retirement and severance and each employment or consulting contract to the extent they exist. There are no other significant employee benefit plans, programs or arrangements, maintained or contributed to by SSWC, other than those listed at Exhibit 3.

SECTION 3.19 Personnel. SSWC has furnished to Chesapeake a list of the names and current salaries of each officer and employee of SSWC as of the date of this Agreement, including a complete and correct list of all written employment, compensation, severance, consulting or indemnification contracts between SSWC and its present or former employees, officers, directors and consultants to the extent SSWC has any continuing obligations thereunder. SSWC has made available to Chesapeake true and correct copies of all such agreements.

SECTION 3.20 Insurance. SSWC has supplied to Chesapeake an accurate and complete list of all policies of fire, liability, workmen's compensation and other forms of insurance owned or held by SSWC. All such policies are in full force and effect, all premiums with respect thereto covering all periods up to and including the Effective Time will have been paid, and no notice of cancellation of termination has been received with respect to any such policy. All known claims, if any, made against SSWC that are covered by insurance have been disclosed to and accepted by the appropriate insurance companies have been previously disclosed to Chesapeake and, to the best knowledge of SSWC, are being defended by such appropriate insurance companies.

SECTION 3.21 Receivables. All accounts and notes due and uncollected as reflected on the Unaudited Financial Statements, and all accounts and notes due and uncollected and arising subsequent to November 30, 1997: (i) have arisen in the ordinary course of business of SSWC; and (ii) represent valid obligations due to SSWC enforceable in accordance with their terms. SSWC has previously made available to Chesapeake lists of the aging and amounts of all accounts and notes due and uncollected at November 30, 1997. SSWC has no agreements, arrangements or commitments with related parties (including stockholders, directors and officers), other than indebtedness that was entered into on an arm's length basis and which is fully reflected on the Unaudited Financial Statements which are a part hereof.

SECTION 3.22 Real Property.

(a) Attached as Exhibit 4 is a true and complete list and description of all real property and land owned by SSWC or either of the Shareholders and used in the business of SSWC, and the buildings, improvements and structures located thereon ("Real Property").

(b) As of the Effective Time, SSWC has or will have good and marketable title to the Real Property in fee simple and to the structures and fixtures attached or appurtenant to the Real Property, free and clear of all Liens, except Permitted Liens.

(c) Neither SSWC nor any Shareholder has received any notice of or writing referring to any requirements or demands by any insurance company that has issued a policy covering any part of any Real Property or by any board of fire underwriters or other body exercising similar functions that any repairs or work be done on any part of the Real Property.

SECTION 3.23 Absence of Certain Payments. Neither SSWC, or any of its affiliates or any of their respective officers, directors, employees or agents or other people acting on behalf of any of them, have engaged in any activity prohibited by the United States Foreign Corrupt Practices Act of 1977 or any other similar law, or, without limiting the generality of the preceding clause, used any corporate or other funds for unlawful contributions, payments, gifts or entertainment, or made any unlawful expenditures relating to political activity to government officials or others.

SECTION 3.24 Disclosure. No representation or warranty by SSWC or either Shareholder in this Agreement, and no statement in any document, schedule or certificate furnished or to be furnished by SSWC or either Shareholder to Chesapeake pursuant to the provisions hereof or in connection with the transactions contemplated hereby, contains any untrue statement of material fact or omits to state any material fact necessary in order to make the statements herein or therein, in light of the circumstance under which they were made, not misleading.

#### ARTICLE IV REPRESENTATIONS AND WARRANTIES OF CHESAPEAKE

Chesapeake represents and warrants to SSWC and the Shareholders as follows:

SECTION 4.1 Corporate Organization. Each of Chesapeake and CPK Sub-B is a corporation duly organized, validly existing and in good standing under the laws of the jurisdiction of its incorporation and has all requisite corporate power and authority to own, lease and operate its properties and to carry on its business as now being conducted. Chesapeake is duly qualified or licensed to do business and is in good standing in each jurisdiction in which the property owned, leased or operated by it or the nature of the business conducted by it makes such qualification or licensing necessary, unless failure to do so would not result in a material adverse effect (for purposes of this Agreement, the phrase "material adverse effect on Chesapeake" will mean such effect on Chesapeake and its subsidiaries, taken as a whole). The Certificate of Incorporation and By-laws of Chesapeake, as currently in effect, are filed as exhibits to Chesapeake's Annual Report on Form 10-K. Chesapeake has heretofore delivered to the Sellers accurate and complete copies of its Certificate of Incorporation and By-laws.



**SECTION 4.2 Authority Relative to this Agreement.** Each of Chesapeake and CPK Sub-B has full corporate power and authority to execute and deliver this Agreement and to consummate the transactions contemplated hereby. The execution and delivery of this Agreement and the consummation of the transactions contemplated hereby have been duly and validly authorized and approved by the Boards of Directors of Chesapeake and CPK Sub-B and by Chesapeake as the sole stockholder of CPK Sub-B and no other corporate proceedings on the part of Chesapeake or CPK Sub-B are necessary to authorize this Agreement or to consummate the transactions so contemplated. This Agreement has been duly and validly executed and delivered by each of Chesapeake and CPK Sub-B and constitutes a legal, valid and binding agreement of each of Chesapeake and CPK Sub-B, enforceable against each of Chesapeake and CPK Sub-B in accordance with its terms.

**SECTION 4.3 Consents and Approvals; No Violations.** Except for the filing and recordation of the Articles of Merger, as required by the MGCL, and the filing with the Delaware Public Utilities Commission, no filing with or notification to and no permit, authorization, consent, waiver or approval of, any Governmental Entity, is necessary for the consummation by Chesapeake of the transactions contemplated by this Agreement. Neither the execution and delivery of this Agreement by Chesapeake or CPK Sub-B nor the consummation by Chesapeake and CPK Sub-B of the transactions contemplated hereby nor compliance by Chesapeake or CPK Sub-B with any of the provisions hereof will: (i) conflict with or result in any breach of any provision of the Certificate of Incorporation or By-Laws of Chesapeake or any of its subsidiaries; (ii) result in a violation or breach of, or constitute a default under, any of the terms, conditions or provisions of any note, bond, mortgage, indenture, license, contract, agreement or other instrument or obligation to which Chesapeake or any of its subsidiaries is a party or by which any of them or any of their respective properties or assets may be bound; (iii) violate any order, writ, injunction, decree, or statute applicable to Chesapeake or CPK Sub-B or any of their properties or assets, or; (iv) result in a violation of any rule or regulation applicable to Chesapeake or CPK Sub-B or any of their properties or assets, unless such violation would not result in a material adverse effect on Chesapeake or CPK Sub-B or the Merger.

**SECTION 4.4 SEC Reports.** Chesapeake has filed on a timely basis all required forms, reports, registration statements and documents with the Securities and Exchange Commission ("SEC") since January 1, 1994 (collectively, the "Chesapeake SEC Reports"), each of which has complied in all materials respects with all applicable requirements of the Securities Act of 1993 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"), as each was in effect on the dates so filed. At the request of SSWC or either of the Shareholders, Chesapeake will deliver Form 10-K's, proxy statements, Quarterly Reports, Form 10-Q's, Annual Reports to Shareholders and/or Form 8-K's as duly filed in the last three (3) fiscal years. The audited consolidated financial statements and unaudited consolidated interim financial statements

of Chesapeake included in the Chesapeake SEC Reports are true, correct and complete in all material respects.

SECTION 4.5 CPK Sub-B. CPK Sub-B has not conducted any operations or incurred any liabilities or obligations other than arising under or in connection with its formation and the transactions contemplated by this Agreement.

SECTION 4.6 Chesapeake Shares. All of the shares of Chesapeake Common Stock to be issued in connection with the Merger will, at the time of such issuance, be validly issued, fully paid and nonassessable and free of preemptive rights and free of any adverse liens, claims, charges or encumbrances.

SECTION 4.7 Disclosure. No representation or warranty by Chesapeake in this Agreement, and no statement contained in any document (including without limitation, the Chesapeake SEC Reports), schedule or certificate furnished or to be furnished by Chesapeake to SSWC or the Shareholders pursuant to the provisions hereof or in connection with the transactions contemplated hereby, contains any untrue statement of material fact or omits to state any material fact necessary in order to make the statements herein or therein, in light of the circumstances under which they were made, not misleading.

SECTION 4.8 Employee Benefit Plans. Chesapeake has previously given to SSWC true and correct copies of its personnel manuals, rules, policies or other guidelines relating to employee compensation and retirement, for those benefits plans and guidelines that will be extended to SSWC employees, including Shareholder Dashiell J. Shannahan, following the Merger. Except as previously disclosed to SSWC and Shareholders in writing, there are no other significant employee benefit plans, programs or arrangements, maintained or contributed to by Chesapeake (excluding the pension plan, severance, employment or consulting contracts, and also excluding the Employment and Non-Competition Agreement attached hereto as Exhibit 7).

## ARTICLE V COVENANTS OF SSWC AND SHAREHOLDERS

SSWC and each of the Shareholders, severally and not jointly, each covenants and agrees as follows:

SECTION 5.1 Conduct of Business Pending the Merger. Except as otherwise specifically provided in this Agreement or as otherwise consented to in writing by Chesapeake, from the date of this Agreement to the Effective Time, SSWC will (and each Shareholder will cause SSWC to) conduct its operations only in the ordinary and usual course of business and consistent with past practices and will preserve intact its present business organization, take all reasonable efforts to keep available the services of its present officers, employees and consultants and preserve its present relationships with

licensors, licensees, customers, suppliers, employees, labor organizations and others with whom it has a significant business relationship. Without limiting the generality of the foregoing, SSWC will not, directly or indirectly (and each Shareholder will cause SSWC not to), from the date of this Agreement to the Effective Time, without the prior written consent of Chesapeake:

(a) adopt any amendment to or otherwise change its Articles of Incorporation or By-laws or other organizational documents;

(b) authorize for issuance, sale, pledge, disposition or encumbrance, or issue, sell, pledge, dispose of or encumber (whether through the issuance or granting of options, warrants, commitments, subscriptions, rights to purchase, convertible securities or otherwise), any capital stock of any class or any other securities of, or any other ownership interest in, SSWC or amend any of the terms of any such securities or agreements outstanding on the date hereof;

(c) reclassify, combine, split or subdivide any shares of its capital stock, declare, set aside or pay any dividend or other distribution (whether in cash, securities or property or any combination thereof) in respect of any class or series of its capital stock;

(d) redeem, purchase or otherwise acquire, or propose or offer to redeem, purchase or otherwise acquire, any outstanding shares of SSWC Common Stock or other securities of SSWC;

(e) organize any new subsidiary, acquire any capital stock or equity securities of any corporation or acquire any equity or ownership interest (financial or otherwise) in any business;

(f) (i) incur, assume or prepay any material liability, including, without limitation, any indebtedness for borrowed money except in the ordinary course of business and consistent with past practice, and in no event in excess of \$50,000, (ii) assume, guarantee, endorse or otherwise become liable or responsible (whether directly, contingently or otherwise) for obligations of any third party, (iii) make any loans, advances or capital contributions to, or investments in, any third party, (iv) mortgage or pledge any of its material properties or assets, tangible or intangible, or create any material Lien thereupon other than Permitted Liens, or (v) authorize any new capital expenditures which, individually or in the aggregate, are in excess of \$20,000;

(g) license (except to end users in the ordinary course of business, consistent with past practice and pursuant to a written license agreement) or otherwise transfer, dispose of, permit to lapse or otherwise fail to preserve any of SSWC's Intellectual Property, or dispose of or disclose to any person any trade secret, formula, process or know-how not heretofore a matter of public knowledge;

(h) enter into any agreement, contract, commitment or transaction other than in the ordinary course of business, consistent with past practices, that would contravene the representation set forth in Section 3.16 hereof, if entered into prior to the date of this Agreement;

(i) increase the compensation payable or to become payable to its officers or employees, except for increases in salary or wages of non-officer employees of SSWC in accordance with past practices, or grant any severance or termination pay or stock options to, or enter into any employment or severance agreement with any director, officer, or other employee of SSWC, or establish, adopt, enter into, or amend any collective bargaining, bonus, profit sharing, thrift, compensation, stock option, restricted stock, pension, retirement, deferred compensation, employment, termination, severance, or other plan, agreement, trust, fund, policy, or arrangement for the benefit of any current or former directors, officers, or employees;

(j) cancel any debts or waive, release or relinquish any material contract rights or other rights of substantial value other than in the ordinary course of business, consistent with past practices;

(k) authorize, recommend, propose or enter into or announce an intention to authorize, recommend, propose or enter into an agreement in principle or a definitive agreement with respect to any merger, consolidation, liquidation, dissolution, or business combination, any acquisition of a material amount of property or assets or securities or any disposition of a material amount of property or assets or securities;

(l) make any material change with respect to accounting policies or procedures except as may be required by generally accepted accounting principles;

(m) pay, discharge or satisfy any claims, liabilities or obligations (absolute, accrued, asserted or unasserted, contingent or otherwise) other than the payment, discharge or satisfaction in the ordinary course of business, consistent with past practice, of liabilities reflected or reserved against in the Unaudited Financial Statements or incurred in the ordinary course of business consistent with past practices since the date hereof; or

(n) commit or agree (in writing or otherwise) to take any of the foregoing actions or any action which would make any representation or warranty in this Agreement untrue or incorrect, including as of the date hereof and as of the Effective Time.

**SECTION 5.2 Access to Information.** Upon reasonable notice and subject to restrictions contained in confidentiality agreements with third parties to which SSWC is subject (from which SSWC shall use reasonable efforts to be released), SSWC shall afford to the officers, employees, accountants, counsel, environmental consultants and other representatives of Chesapeake, reasonable access, during normal business hours during the period prior to the Effective Time, to all its properties, books, contracts,

commitments and records and, during such period, SSWC shall furnish promptly to Chesapeake all information concerning its business, properties and personnel as Chesapeake may reasonably request.

SECTION 5.3 No Solicitation. Shareholders and SSWC will not initiate or solicit, directly or indirectly, any inquiries or the making of any proposal with respect to, or engage in negotiations concerning, provide any information or data to, or have any discussions with any Third Party (as hereinafter defined) relating to, any public offering of securities of, or acquisition, business combination or purchase of all or any significant portion of the properties or assets of, or any equity interest in, SSWC (an "Acquisition Proposal"). Shareholders and SSWC will immediately cease any existing activities, discussions or negotiations with any Third Party conducted heretofore with respect to any Acquisition Proposal. Shareholders and SSWC shall immediately notify Chesapeake if, subsequent to the date hereof, any such negotiations, provision of information or data or discussions are entered into or made or any such inquiries are received in respect thereof, and shall provide details with, including the identity of such Third Party and the price and terms of any Proposal. As used in this Agreement, the term "Third Party" means any "group", as such terms are defined in Section 13(d) of the Exchange Act, other than Chesapeake or any affiliate of Chesapeake.

SECTION 5.4 Further Information. As soon as practicable after such information becomes available, and in any event not later than thirty (30) days after the end of each fiscal month, SSWC shall provide to Chesapeake an unaudited balance sheet as of the end of such month and the related consolidated statements of results of operations and statements of cash flows for such period.

SECTION 5.5 Affiliates. Prior to the execution of this Agreement, SSWC shall deliver to Chesapeake a letter identifying all persons who may be deemed, as of the date of this Agreement, "affiliates" of SSWC for purposes of Rule 145 under the Securities Act. SSWC shall cause each person named in such letter to deliver a written agreement substantially in the form attached hereto as Exhibit 5.

## ARTICLE VI COVENANTS OF CHESAPEAKE

SECTION 6.1 Employment Matters. It is Chesapeake's present intention to integrate, following the Effective Time, certain employee benefit plans currently maintained by Chesapeake and its subsidiaries and SSWC, respectively. To the extent that SSWC employees become participants in any such plans of Chesapeake and its subsidiaries ("Chesapeake Plans") following the Effective Time, SSWC employees shall be credited under the Chesapeake Plans for prior years of service with SSWC for purposes of eligibility and vesting, to the extent such service was recognized by SSWC under any similar employee benefit plan. With respect to Chesapeake's pension plan, SSWC employees will not become participants. With respect to the Chesapeake 401(k)

Plan, SSWC employees will not be entitled to retroactive matching contributions for years of service prior to the Effective Time.

SECTION 6.2 Release of Personal Guaranties. At the Effective Time, Chesapeake shall pay all indebtedness of SSWC that has been reasonably incurred in connection with its business and is guaranteed or co-signed by a Shareholder. Exhibit 6 hereof includes a complete schedule of all such indebtedness currently outstanding.

## ARTICLE VII MUTUAL COVENANTS

SECTION 7.1 Reasonable Efforts. Subject to the terms and conditions of this Agreement, each of the parties hereto agrees to use all reasonable efforts to take, or cause to be taken, all actions, and to do, or cause to be done, all things necessary, proper or advisable to assure that all conditions to Closing set forth in Article VIII of this Agreement are satisfied as expeditiously as possible including, without limitation, the preparation and filing of all forms, registrations and notices required to be filed to consummate the transactions contemplated hereby and the taking of such actions as are necessary to obtain any requisite approvals, consents, orders, exemptions, or waivers by any public or private third party. Each party shall promptly consult with the other with respect to, provide any necessary information with respect to, and provide the other (or its counsel) copies of all filings made by such party with any Governmental Entity in connection with this Agreement and the transactions contemplated hereby.

SECTION 7.2 Brokers or Finders. No agent, broker, investment banker, financial advisor or other firm or person is or will be entitled to any brokers' or finder's fee or any other commission or similar fee in connection with any of the transactions contemplated by this Agreement.

SECTION 7.3 Notification of Certain Matters. SSWC and each of the Shareholders shall give prompt notice to Chesapeake and CPK Sub-B, and Chesapeake and CPK Sub-B shall give prompt notice to SSWC and Shareholders, of the occurrence (or non-occurrence) of any event which would be likely to cause any representation or warranty contained in this Agreement to be untrue or inaccurate in any respect (including as of the Effective Time) and of any failure of either party to comply with or satisfy any covenant, condition or agreement to be complied with or satisfied by it hereunder; provided, however, that delivery of any notice pursuant to this Section 7.3 shall not limit or otherwise affect the remedies available to either party hereunder.

SECTION 7.4 Fees and Expenses. Whether or not the Merger is consummated, all costs and expenses incurred in connection with this Agreement and the transactions contemplated hereby, including the parties' respective legal fees, shall be paid by the party incurring such expenses, except that Chesapeake will reimburse such expenses of SSWC or Shareholders up to a maximum of \$\_\_\_\_\_.

SECTION 7.5 Further Assurances. After the Closing, Chesapeake and the Shareholders shall from time to time, at the request of the other party and without further cost or expense to the requesting party, execute and deliver such other instruments of conveyance and transfer and take such other actions as such other party may reasonably request in order more effectively to carry out this Agreement.

## ARTICLE VIII CONDITIONS

SECTION 8.1 Conditions to Each Party's Obligation to Effect the Merger. The respective obligations of each party to effect the Merger shall be subject to the satisfaction at or prior to the Effective Time of the following conditions:

(a) No statute, rule, regulation, executive order, decree or injunction, by any United States court or Governmental Entity of competent jurisdiction, shall be in effect that prohibits the consummation of the Merger.

(b) The Closing shall have taken place no later than April 30, 1998.

SECTION 8.2 Conditions of Obligations of SSWC and the Shareholders. The obligation of SSWC and the Shareholders to effect the Merger is further subject to the satisfaction at or prior to the Effective Time of the following conditions, unless waived by SSWC and the Shareholders:

(a) The representations and warranties of Chesapeake set forth in this Agreement shall be true and correct in all material respects as of the date of this Agreement and as of the Effective Time.

(b) Chesapeake shall have performed and complied, in all material respects, with all obligations, covenants and conditions required to be performed or complied with by it under this Agreement at or prior to the Effective Time.

(c) Chesapeake shall have obtained all consents, approvals, authorizations and permits required from third parties and any Governmental Entity (applicable to Chesapeake and its subsidiaries) necessary for the consummation by Chesapeake of the transactions contemplated by this Agreement.

(d) Chesapeake shall have executed and delivered an Employment and Non-Competition Agreement with Dashiell J. Shannahan substantially in the form of Exhibit 7 attached hereto.

(e) SSWC and the Shareholders shall have received from legal counsel for Chesapeake an opinion substantially in the form of Exhibit 8 attached hereto.

(f) From the date of this Agreement through the Effective Time, Chesapeake shall not have suffered a Material Adverse Change.

(g) The Chesapeake shares to be issued pursuant to this Agreement shall have been listed on the New York Stock Exchange.

SECTION 8.3 Conditions of Obligations of Chesapeake. The obligation of Chesapeake to effect the Merger is further subject to the satisfaction at or prior to the Effective Time of the following conditions, unless waived by Chesapeake:

(a) The representations and warranties of SSWC and the Shareholders set forth in this Agreement shall be true and correct in all material respects as of the date of this Agreement and as of the Effective Time.

(b) SSWC and the Shareholders shall have performed and complied with, in all material respects, all obligations, covenants and conditions required to be performed or complied with by it under this Agreement at or prior to the Effective Time.

(c) SSWC and the Shareholders shall have obtained all consents, approvals, authorizations and permits required from third parties and any Governmental Entity (applicable to SSWC) necessary for the consummation by SSWC and the Shareholders of the transactions contemplated by this Agreement.

(d) Dashiell J. Shannahan shall have executed and delivered an Employment and Non-Competition Agreement with Chesapeake substantially in the form of Exhibit 7 attached hereto.

(e) The lands and improvements, presently titled in the name of Shareholder Dashiell J. Shannahan, individually (which is part of the Real Property, as defined herein and more particularly described on Exhibit 4), shall be retitled in the name of SSWC, at or prior to the Effective Time.

(f) Chesapeake shall have received from counsel to the Shareholders and to SSWC an opinion substantially in the form of Exhibit 9 attached hereto.

(g) Chesapeake shall have received from each Shareholder an investment letter, substantially in the form of Exhibit 10 attached hereto.

(h) From the date of this Agreement through the Effective time, SSWC shall not have suffered a Material Adverse Change.

(i) All necessary approvals from the Delaware Public Service Commission regarding the issuance of the shares of Chesapeake Common Stock shall have been granted by final order.



(j) The results of the due diligence investigation being conducted by Chesapeake with respect to SSWC, shall be acceptable to Chesapeake, in Chesapeake's sole discretion.

## ARTICLE IX SURVIVAL AND INDEMNIFICATION

SECTION 9.1 Survival of Representations and Warranties. All statements, certifications, representations, warranties, covenants, agreements and obligations provided for herein shall survive beyond the Effective Time and continue (and shall not in any manner be affected or impaired by the consummation of the transactions contemplated by this Agreement) until the time specified in Section 9.2 hereof or until the termination of this Agreement pursuant to Section 10.1.

### SECTION 9.2 Indemnification.

#### (a) Indemnity by Chesapeake.

(i) Chesapeake shall indemnify and defend and hold each Shareholders harmless from and against all claims, liabilities, damages, losses and expenses (including reasonable attorneys' fees) of every kind and character (exclusive of any amounts covered by Section 9.2(b)) resulting from or relating to or arising out of the inaccuracy, nonfulfillment, nonperformance or breach of any representation, warranty, covenant, agreement or obligation of Chesapeake contained herein.

(ii) No Shareholder shall have any claim for indemnification hereunder unless such claim is asserted not later than the earlier of (A) one year following the Effective Time or (B) the date on which an independent audit report on Chesapeake is issued which reflects the Merger; but if such claim is asserted within such time period, any such Shareholder's right to indemnification for such matters shall continue until such liability is finally determined by written settlement between the parties involved or by a final judgment ordered by a court of competent jurisdiction. No indemnification shall be payable to Shareholders in excess of \$200,000, exclusive of amounts payable as a result of a knowing, fraudulent, or intentional breach by Chesapeake.

#### (b) Indemnity by the Shareholders.

(i) Shareholders shall indemnify and defend and hold Chesapeake and its affiliates harmless from and against all claims, liabilities, damages, losses and expenses (including reasonable attorneys' fees) of every kind and character (exclusive of any amounts covered by Section 9.2(a)) resulting from or relating to or arising out of the inaccuracy, nonfulfillment, nonperformance or breach of any representation warranty, covenant, agreement or obligation of Shareholders or SSWC contained herein.

(ii) Chesapeake shall have no claim for indemnification hereunder unless such claim is asserted not later than the earlier of (A) one year following the Effective Time or (B) the date on which an independent audit report on Chesapeake is issued which reflects the Merger; but if such claim is asserted within such time period, Chesapeake's right to indemnity for such matters shall continue until such liability is finally determined by written settlement between the parties involved or by a final judgment ordered by a court of competent jurisdiction. No indemnification shall be payable to Chesapeake in excess of \$200,000 exclusive of amounts payable as a result of knowing, fraudulent or intentional breach by either Shareholder.

(c) Each Shareholder's rights to indemnification hereunder may not be transferred or assigned, except in accordance with the laws of descent and distribution.

(d) Amounts due to or by Chesapeake under this Article IX shall be paid, to the extent held or other limit prescribed by law or regulation, in Chesapeake Common Stock. For purposes of this Section 9.2(d), the value of such Chesapeake Common Stock shall be deemed to be the closing market price of the Common Stock as of the Effective Time.

## ARTICLE X TERMINATION AND AMENDMENT

SECTION 10.1 Termination. This Agreement may be terminated at any time prior to the Effective Time:

(a) by mutual consent of Chesapeake, SSWC and the Shareholders;

(b) by either Chesapeake or the Shareholders, if the Closing shall not have been consummated on or before April 30, 1998 (unless the failure to consummate the merger by such date shall be due to the action or failure to act of the party seeking to terminate);  
or

(c) by either Chesapeake, SSWC or the Shareholders, if any permanent injunction or other order of a court or other competent authority preventing the consummation of the Merger shall have become final and nonappealable.

SECTION 10.2 Effect of Termination. In the event of the termination and abandonment of this Agreement pursuant to Section 10.1 hereof, this Agreement shall forthwith become void and have no effect, without any liability on the part of any party hereto or its affiliates, directors, officers or stockholders. Notwithstanding the foregoing, nothing contained in this Section 10.2 shall relieve any party from liability for any material breach of any covenant of this Agreement or any material breach or misrepresentation of the representations or warranties contained herein.

SECTION 10.3 Amendment. This Agreement may be amended by the parties hereto at any time prior to the Effective Time. This Agreement may not be amended except by an instrument in writing executed by all the parties hereto.

SECTION 10.4 Extension; Waiver. At any time prior to the Effective Time, the parties may, to the extent legally allowed: (i) extend the time for the performance of any of the obligations or other acts of the other parties hereto, (ii) waive any inaccuracies in the representations and warranties of the other parties hereto contained herein or in any document delivered pursuant hereto and (iii) waive compliance with any of the agreements or conditions contained herein by the other parties hereto. Any agreement on the part of a party hereto to any such extension or waiver shall be valid only if set forth in a written instrument.

#### ARTICLE XI MISCELLANEOUS

SECTION 11.1 Notices. All notices and other communications hereunder shall be in writing, and shall be deemed given upon receipt if delivered personally, sent by facsimile transmission or by certified or registered mail, return receipt requested, or by a nationally recognized private overnight courier to the parties at the following addresses:

(a) if to SSWC, to:

Sam Shannahan Well Company, Inc., d/b/a  
Tolan Water Service  
Attention: Duke Shannahan, President  
716 Naylor Mill Road  
Salisbury, MD 21801

with a copy to:

H. Michael Hickson, Esquire  
Banks, Nason & Hickson  
113 Baptist Street  
Salisbury, MD 21801

(b) if to the Shareholders to:

Dashiell J. Shannahan  
Joyce C. Shannahan  
917 Camden Avenue  
Salisbury, MD 21801

with a copy to:

H. Michael Hickson, Esquire  
Banks, Nason & Hickson  
113 Baptist Street  
Salisbury, MD 21801

(c) if to Chesapeake, to:

Chesapeake Utilities Corporation  
Attention: John R. Schimkaitis, President  
909 Silver Lake Boulevard  
Dover, Delaware 19904

with a copy to:

Victor H. Laws, III, Esquire  
Laws & Laws, P.A.  
209 East Main Street  
P.O. Box 75  
Salisbury, MD 21803-0075

SECTION 11.2 Descriptive Headings. The descriptive headings herein are inserted for convenience only and are not intended to be part of or to affect the meaning or interpretation of this Agreement.

SECTION 11.3 Counterparts. This Agreement may be executed in two or more counterparts, all of which shall be considered one and the same agreement and shall become effective when two or more counterparts have been signed by each of the parties and delivered to the other parties, it being understood that all parties need not sign the same counterpart.

SECTION 11.4 Entire Agreement; Successors and Assigns.

(a) This Agreement constitutes the entire agreement and supersedes all prior agreements and understanding, both written and oral, among the parties with respect to the subject matter hereof.

(b) This Agreement shall be binding upon, and inure to the benefit of the parties hereto and their heirs, successors, and permitted assigns. As used herein, the successors of a party shall include, but not be limited to, any successor by way of merger, consolidation, sale or transfer of all or substantially all of its assets (pursuant to liquidation or otherwise) or similar reorganization. In no event may either Shareholder assign any rights or duties under this Agreement, except with Chesapeake's written consent.

SECTION 11.5 Governing Law. This Agreement shall be governed and construed in accordance with the laws of the State of Maryland.

SECTION 11.6 Specific Performance. The parties hereto agree that if any of the provisions of this Agreement were not performed in accordance with their specific terms or were otherwise breached, irreparable damage would occur, no adequate remedy at law would exist and damages would be difficult to determine, and that the parties shall be entitled to specific performance of the terms hereof, in addition to any other remedy at law or equity.

SECTION 11.7 Publicity. Chesapeake may issue or cause the publication of any press release or other public announcement or make any filing with the SEC with respect to the transactions contemplated by this Agreement as it deems appropriate. Neither SSWC nor Shareholders shall issue or cause the publication of any press release or other public announcement with respect to the transactions contemplated by this Agreement without the prior approval of Chesapeake.

SECTION 11.9 Confidentiality Agreements. At the Effective Time, the Confidentiality Agreements dated January 28, 1998 between Chesapeake and SSWC and the Shareholders will terminate and have no further force or effect.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be signed (where applicable by their respective officers thereunto duly authorized), as of the date first written above.

ATTEST:

CHESAPEAKE UTILITIES  
CORPORATION

\_\_\_\_\_

By: \_\_\_\_\_ (SEAL)  
John R. Schimkaitis, President

ATTEST:

SAM SHANNAHAN WELL COMPANY,  
INC., d/b/a TOLAN WATER SERVICE

\_\_\_\_\_

By: \_\_\_\_\_ (SEAL)  
Dashiell J. Shannahan, President

ATTEST:

CPK SUB-B, INC.

\_\_\_\_\_

By: \_\_\_\_\_ (SEAL)  
Authorized Officer

WITNESS:

\_\_\_\_\_  
Dashiell J. Shannahan (SEAL)

WITNESS:

\_\_\_\_\_  
Joyce C. Shannahan (SEAL)

STATE OF DELAWARE  
COUNTY OF KENT:

I HEREBY CERTIFY that on this \_\_\_\_ day of \_\_\_\_\_, 1998,  
before me, the undersigned officer, personally appeared John R. Schimkaitis, President of  
Chesapeake Utilities Corporation, and on its behalf did acknowledge the foregoing  
Agreement and Plan of Merger to be the act and deed of said corporation.

AS WITNESS my hand and notarial seal.

My Commission Expires: \_\_\_\_\_

STATE OF DELAWARE  
COUNTY OF KENT:

I HEREBY CERTIFY that on this \_\_\_\_ day of \_\_\_\_\_, 1998,  
before me, the undersigned officer, personally appeared \_\_\_\_\_, Authorized  
Officer of CPK Sub-B, Inc., and on its behalf did acknowledge the foregoing Agreement  
and Plan of Merger to be the act and deed of said corporation.

AS WITNESS my hand and notarial seal.

My Commission Expires: \_\_\_\_\_

STATE OF MARYLAND  
COUNTY OF WICOMICO:

I HEREBY CERTIFY that on this \_\_\_\_ day of \_\_\_\_\_, 1998,  
before me, the undersigned officer, personally appeared Dashiell J. Shannahan, President  
of SSWC, d/b/a SSWC Water Services, Inc., and on its behalf did acknowledge the  
foregoing Agreement and Plan of Merger to be the act and deed of said corporation.

AS WITNESS my hand and notarial seal.

My Commission Expires: \_\_\_\_\_

STATE OF MARYLAND  
COUNTY OF WICOMICO:

I HEREBY CERTIFY that on this \_\_\_\_ day of \_\_\_\_\_, 1998,  
before me, the undersigned officer, personally appeared Dashiell J. Shannahan,  
Shareholder, Tolan Water Services, Inc., and on its behalf did acknowledge the foregoing  
Agreement and Plan of Merger to be the act and deed of said corporation.

AS WITNESS my hand and notarial seal.

My Commission Expires: \_\_\_\_\_

STATE OF MARYLAND  
COUNTY OF WICOMICO:

I HEREBY CERTIFY that on this \_\_\_\_ day of \_\_\_\_\_, 1998,  
before me, the undersigned officer, personally appeared Joyce C. Shannahan,  
Shareholder, Tolan Water Services, Inc., and on its behalf did acknowledge the foregoing  
Agreement and Plan of Merger to be the act and deed of said corporation.

AS WITNESS my hand and notarial seal.

My Commission Expires: \_\_\_\_\_

SCHMITTINGER AND RODRIGUEZ, P.A.

LAWYERS

414 SOUTH STATE STREET

P.O. BOX 497

DOVER, DELAWARE 19903-0497

TELEPHONE (302) 674-0140

TELECOPIER (302) 674-1830

HAROLD SCHMITTINGER  
NICHOLAS H. RODRIGUEZ  
PAUL H. BOSWELL  
JOHN J. SCHMITTINGER  
BRUCE C. ENNIS  
LARRY W. FIFER  
DOUGLAS B. CATTS  
WILLIAM D. FLETCHER, JR.  
WILLIAM A. DENMAN  
JAMES T. VAUGHN, JR.  
CATHERINE T. HICKEY  
WILLIAM W. PEPPER, SR.  
CRAIG T. ELIASSEN  
CRYSTAL L. CAREY\*  
SCOTT E. CHAMBERS\*  
MARDI F. PYOTT\*  
NOEL E. PRIMOS  
DAVID A. BOSWELL  
MICHELE L. PROCINO  
WALT F. SCHMITTINGER  
JEFFREY J. CLARK  
R. SCOTT KAPPES  
KATHY S. GRAVELL\*

\*ALSO ADMITTED IN MARYLAND

WILMINGTON OFFICE  
BRANDYWINE GATEWAY PLAZA  
1300 N. MARKET STREET, SUITE 205  
WILMINGTON, DELAWARE 19801  
TELEPHONE (302) 652-3676  
TELECOPIER (302) 652-8788

REHOBOTH BEACH OFFICE  
4602 HIGHWAY ONE  
CORESTATES BUILDING  
REHOBOTH BEACH, DELAWARE 19971  
TELEPHONE (302) 227-1400  
TELECOPIER (302) 645-1843

ODESSA OFFICE  
ODESSA PROFESSIONAL PARK  
P.O. BOX 626  
ODESSA, DELAWARE 19730-0626  
TELEPHONE (302) 378-1697  
TELECOPIER (302) 378-1659

March 2, 1998

Delaware Public Service Commission  
Cannon Building, Suite 100  
861 Silver Lake Boulevard  
Dover, DE 19904

RE: Application of Chesapeake Utilities Corporation  
For The Approval of Issuance of Stock

Dear Commissioners:

We are Delaware counsel for Chesapeake Utilities Corporation ("Chesapeake") in connection with Chesapeake's application for Commission approval of the issuance of approximately 33,000 shares of Chesapeake common stock, pursuant to 26 Del. C. §215.

We are familiar with the terms, interpretation, and application of 26 Del. C. §215 which sets forth the required, but limited, findings to be made by the Commission in its consideration of such a proposed issue. We note the limited scope of Commission review, as determined by the Delaware Supreme Court in the Diamond State Telephone Company case, 367 A.2d 644 (1976). Specifically, in the Diamond State Telephone Company case, the Delaware Supreme Court held that the powers legislated to the Commission pursuant to 26 Del. C. §215 were intended to be applied in cases of a proposed issuance of stock for an inadequate consideration or for some other improper purpose. In Diamond State, the Delaware Supreme Court stated that in the absence of a showing of improper consideration, fraud, bad faith, or self-dealing on the part of the members of a utility's board of directors in their decision to issue shares of stock for the purpose of raising needed funds, it would be improper for the Commission to substitute its judgment for that of the board of directors.



Delaware Public Service Commission  
March 2, 1998  
Page 2

Based upon our knowledge of the applicable statute, and its regulatory and judicial interpretation and application, it is our opinion that the proposed issuance of approximately 33,000 shares of Chesapeake common stock has been duly authorized and is valid and in accordance with law, subject, of course, to the approval of the Public Service Commission pursuant to 26 Del. C. §215, any necessary approval on the part of the Florida Public Service Commission, and satisfactory compliance by Chesapeake with all applicable federal securities laws.

It is also our opinion, based upon the statement of Chesapeake's intended purpose for issuing said stock, that the subject stock issue is for a proper purpose, and is consistent with the public interest, by enabling Chesapeake to acquire Sam Shannahan Well Company, Inc.

Accordingly, it is our opinion that Chesapeake's pending application for Commission approval pursuant to 26 Del. C. §215 fully complies with the limited statutory requirements and findings necessary for Commission approval.

Sincerely yours,

SCHMITTINGER & RODRIGUEZ, P.A.

BY: 

WILLIAM A. DENMAN, ESQUIRE

WAD:pmw

UNAUDITED

	ACTUAL BEFORE ISSUANCE	ADJUSTMENT	PRO FORMA BEFORE ISSUANCE	ISSUANCE OF COMMON STOCK	PRO FORMA AFTER ISSUANCE OF EQUITY
ASSETS					
PROPERTY, PLANT AND EQUIPMENT					
At original cost	\$140,954,367		\$140,954,367	\$910,746	\$141,865,113
Less: Accum. depreciation and amortization	(42,800,914)		(42,800,914)	(420,957)	(43,221,871)
Net property, plant and equipment	98,153,453	0	98,153,453	489,789	98,643,242
INVESTMENTS	2,340,007	0	2,340,007	0	2,340,007
CURRENT ASSETS					
Cash and cash equivalents	1,467,700		1,467,700	44,516	1,512,216
Accounts receivable, net	7,357,140		7,357,140	87,159	7,444,299
Materials and supplies	1,684,040		1,684,040	47,661	1,731,701
Propane inventory	2,426,356		2,426,356	0	2,426,356
Storage gas prepayments	4,005,715		4,005,715	0	4,005,715
Other prepaid expenses	750,720		750,720	7,268	757,988
Deferred income taxes	813,681		813,681	0	813,681
Underrecovered purchased gas costs	203,556		203,556	0	203,556
Total current assets	18,708,908	0	18,708,908	186,604	18,895,512
DEFERRED CHARGES					
Environmental regulatory assets	6,501,505		6,501,505	0	6,501,505
Environmental expenditures, net	2,262,938		2,262,938	0	2,262,938
Order 636 Transition cost	0		0	0	0
Other deferred charges & intangible assets	3,853,401		3,853,401	264,084	4,117,485
Total deferred charges & other assets	12,617,844	0	12,617,844	264,084	12,881,928
TOTAL ASSETS	\$131,820,212	\$0	\$131,820,212	\$940,477	\$132,760,689

UNAUDITED

LIABILITIES AND CAPITALIZATION	ACTUAL BEFORE ISSUANCE	ADJUSTMENT	PRO FORMA BEFORE ISSUANCE	ISSUANCE OF COMMON STOCK	PRO FORMA AFTER ISSUANCE OF EQUITY
<b>CAPITALIZATION</b>					
Common stock	\$2,181,014		\$2,181,014	\$16,061	\$2,197,075
Additional paid-in capital	19,433,279		19,433,279	34,939	19,468,218
Retained earnings	26,947,738		26,947,738	144,536	27,092,274
Less: Unearned compensation	(234,348)		(234,348)	0	(234,348)
Net unrealized gain on mkt. securities	64,560		64,560	0	64,560
Total stockholders' equity	48,392,243	0	48,392,243	195,536	48,587,779
<b>LONG-TERM DEBT, NET OF CURRENT</b>	28,642,000	10,000,000	38,642,000	0	38,642,000
<b>TOTAL CAPITALIZATION</b>	77,034,243	10,000,000	87,034,243	195,536	87,229,779
<b>CURRENT LIABILITIES</b>					
Current portion of long-term debt	659,868		659,868	0	659,868
Short-term borrowings	18,400,000	(10,000,000)	8,400,000	649,076	9,049,076
Accounts payable	6,348,741		6,348,741	80,633	6,429,374
Refunds payable to customers	336,575		336,575	0	336,575
Accrued interest	619,444		619,444	0	619,444
Overrecovered purchased gas costs	0		0	0	0
Dividends payable	1,086,650		1,086,650	0	1,086,650
Income taxes payable	216,574		216,574	0	216,574
Other accrued expenses	3,862,271		3,862,271	15,232	3,877,503
Total current liabilities	31,530,123	(10,000,000)	21,530,123	744,941	22,275,064
<b>DEFERRED CREDITS</b>					
Deferred income taxes	10,230,179		10,230,179	0	10,230,179
Deferred investment tax credits	840,201		840,201	0	840,201
Environmental liability	6,501,505		6,501,505	0	6,501,505
Accrued pension costs	2,230,258		2,230,258	0	2,230,258
Order 636 transition liability	0		0	0	0
Other liabilities	3,453,703		3,453,703	0	3,453,703
Total deferred credits and other liabilities	23,255,846	0	23,255,846	0	23,255,846
<b>TOTAL LIABILITIES AND CAPITALIZATION</b>	<u>\$131,820,212</u>	<u>\$0</u>	<u>\$131,820,212</u>	<u>\$940,477</u>	<u>\$132,760,689</u>

CHESAPEAKE UTILITIES CORPORATION  
Annualized Consolidated Income Statement  
For the Twelve Months Ended September 30, 1997

EXHIBIT C  
Page 3 of 4

UNAUDITED

	ACTUAL BEFORE ISSUANCE	ADJUSTMENT	PRO FORMA BEFORE ISSUANCE	ISSUANCE OF COMMON STOCK	PRO FORMA AFTER ISSUANCE OF EQUITY
OPERATING REVENUES	\$124,669,424	\$0	\$124,669,424	\$1,539,638	\$126,209,062
OPERATING EXPENSES					
Purchased gas costs	75,630,932		75,630,932	0	75,630,932
Operations	26,404,834		26,404,834	1,223,093	27,627,927
Maintenance	2,216,559		2,216,559	73,643	2,290,202
Depreciation and amortization	5,353,076		5,353,076	61,496	5,414,572
Taxes-other than income	3,824,831		3,824,831	58,059	3,882,890
Taxes-income	3,186,411		3,186,411	34,730	3,221,141
Total Operating Expenses	116,616,643	0	116,616,643	1,451,021	118,067,664
NET OPERATING INCOME	8,052,781	0	8,052,781	88,617	8,141,398
OTHER INCOME AND DEDUCTIONS	377,347	0	377,347	1,290	378,637
INCOME BEFORE INTEREST CHARGES	8,430,128	0	8,430,128	89,907	8,520,035
INTEREST CHARGES					
Interest - Long-Term Debt	2,339,859	685,000	3,024,859	0	3,024,859
Interest - Short Term Borrowings	623,776	(562,680)	61,096	36,522	97,618
Interest - Other	247,838		247,838	0	247,838
Amortization of Debt Expense	115,632		115,632	0	115,632
Capital Leases	0		0	0	0
AFUDC	(82,964)		(82,964)	0	(82,964)
Total Interest Charges	3,244,141	122,320	3,366,461	36,522	3,402,983
TOTAL NET INCOME	\$5,185,987	(\$122,320)	\$5,063,667	\$53,385	\$5,117,052

The following adjustments have been made to the Income Statement and Balance Sheet for September 30, 1997:

- (1) The results as of September 30, 1997 have been adjusted to reflect the 6.85%, \$10 million long-term debt financing consummated on December 15, 1997 by Chesapeake.
- (2) A reclass was made between Common stock and Additional paid-in capital for SSWC so that the Common stock number would represent 33,000 shares of Chesapeake stock at a par value of \$.4867.
- (3) All notes payable, mortgages payable, and loans payable of SSWC would be paid off by Chesapeake at closing. Chesapeake would increase its short-term borrowings to pay off these items.
- (4) Interest expense was recalculated using Chesapeake's average short-term borrowing interest rate for 1997, which was 5.6268%. An adjustment was made to both long-term and short-term interest as a result of the \$10 million financing on December 15, 1997. Interest was also recalculated on the SSWC indebtedness that will be paid off by Chesapeake at closing.
- (5) SSWC does not record income taxes each month, but rather waits until the end of the respective fiscal year, August 31. Income taxes for a full year were calculated at 40%.

As filed with the Securities and Exchange Commission on March 19, 1997

**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-K**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15 (d) OF  
THE SECURITIES EXCHANGE ACT OF 1934**

For the Fiscal Year Ended December 31, 1996      Commission File Number 0-593

**CHESAPEAKE UTILITIES CORPORATION**

(Exact name of registrant as specified in its charter)

State of Delaware  
(State or other jurisdiction of  
incorporation or organization)

51-0064146  
(I.R.S. Employer  
Identification No.)

909 Silver Lake Boulevard, Dover, Delaware  
(Address of principal executive offices)

19904  
(Zip Code)

Registrant's telephone number, including area code: 302-734-6713

Securities registered pursuant to Section 12(b) of the Act:

Title of each class  
Common Stock - par value per share \$.4867

Name of each exchange on which registered  
New York Stock Exchange, Inc.

Securities registered pursuant to Section 12(g) of the Act:

8.25% Convertible Debentures Due 2014  
(Title of class)

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendments to this Form 10-K. [X]

As of March 14, 1997, 4,452,704 shares of common stock were outstanding. The aggregate market value of the common shares held by non-affiliates of Chesapeake Utilities Corporation, based on the last trade price on March 14, 1997, as reported by the New York Stock Exchange, was approximately \$78,478,908.

**DOCUMENTS INCORPORATED BY REFERENCE**

**DOCUMENTS**  
Definitive Proxy Statement dated April 4, 1997

**PART OF FORM 10-K**  
Part III

**CHESAPEAKE UTILITIES CORPORATION**  
**FORM 10-K**

**Year Ended December 31, 1996**

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## PART I

### Item 1. Business

#### (a) General Development of Business

Chesapeake Utilities Corporation ("Chesapeake" or "the Company") is a diversified utility company engaged in natural gas distribution and transmission, propane distribution and advanced information services.

Chesapeake's three natural gas distribution divisions serve approximately 34,700 residential, commercial and industrial customers in southern Delaware, Maryland's Eastern Shore and Central Florida. The Company's natural gas transmission subsidiary Eastern Shore Natural Gas Company ("Eastern Shore"), operates a 271-mile interstate pipeline system that transports gas from various points in Pennsylvania to the Company's Delaware and Maryland distribution divisions, as well as to other utilities and industrial customers in Delaware and the Eastern Shore of Maryland. The Company's propane segment serves approximately 23,100 customers in southern Delaware and the Eastern Shore of Maryland and Virginia. The advanced information services segment provides software services and products to a wide variety of customers and clients.

#### (b) Financial Information About Industry Segments

For the Years Ended December 31,	1996	1995	1994
<b>Operating Revenues, Unaffiliated Customers</b>			
Natural gas distribution	\$74,904,076	\$54,120,280	\$49,523,743
Natural gas transmission	15,188,777	24,984,767	22,191,896
Propane distribution	22,333,969	17,607,956	20,684,150
Advanced information services and other	6,903,246	7,307,413	6,172,508
Total operating revenues, unaffiliated customers	<u>\$119,330,068</u>	<u>\$104,020,416</u>	<u>\$98,572,297</u>
<b>Intersegment Revenues *</b>			
Natural gas distribution	\$8,711	\$42,037	\$55,888
Natural gas transmission	21,543,327	16,663,043	17,303,529
Propane distribution	2,059	139,052	85,552
Advanced information services and other	710,949	1,722,135	2,277,361
Total intersegment revenues	<u>\$22,265,046</u>	<u>\$18,566,267</u>	<u>\$19,722,330</u>
<b>Operating Income Before Income Taxes</b>			
Natural gas distribution	\$7,167,236	\$4,728,348	\$4,696,659
Natural gas transmission	2,458,442	6,083,440	3,018,212
Propane distribution	2,053,299	1,852,630	2,287,688
Advanced information services and other	1,305,203	1,170,970	174,033
Total	12,984,180	13,835,388	10,176,592
Add (Less): Eliminations	206,580	(248,595)	(419,883)
Total operating income before income taxes	<u>\$13,190,760</u>	<u>\$13,586,793</u>	<u>\$9,756,709</u>
<b>Identifiable Assets, at December 31,</b>			
Natural gas distribution	\$81,250,030	\$75,630,741	\$68,528,774
Natural gas transmission	23,981,989	19,292,524	17,792,415
Propane distribution	20,791,588	18,855,507	16,949,431
Advanced information services	1,496,418	1,635,100	3,196,064
Other	3,617,885	3,380,108	1,803,933
Total identifiable assets	<u>\$131,137,910</u>	<u>\$118,793,980</u>	<u>\$108,270,617</u>

\* All significant intersegment revenues have been eliminated from consolidated revenues.



### **(c) Narrative Description of Business**

The Company is engaged in four primary business activities: natural gas transmission; natural gas distribution; propane distribution; and advanced information services. In addition to the four primary groups, Chesapeake has three subsidiaries engaged in other service related businesses. During 1996 and 1994, no individual customer accounted for 10% or more of operating revenues. In 1995, the Company had sales to one customer, Texaco Refining and Marketing, an industrial interruptible customer of Eastern Shore, which exceeded 10% of total revenue. Total sales to this customer were approximately \$10.6 million or 10.2% of total revenue during 1995.

#### ***(i) (a) Natural Gas Transmission***

Eastern Shore, the Company's wholly owned transmission subsidiary, operates an interstate pipeline that delivers gas to five utility and thirteen industrial customers in Delaware and the Eastern Shore of Maryland. Eastern Shore is the sole source of gas supply for Chesapeake's Maryland and Delaware divisions and for two unaffiliated distribution entities. During 1996 and previously, Eastern Shore was not an open access pipeline (see competition within natural gas industry) which would provide transportation service to all customers. However, Eastern Shore has authority from the Federal Energy Regulatory Commission ("FERC") to provide firm transportation to two of its customers for gas they own and deliver to Eastern Shore for redelivery.

#### ***Natural Gas Supply***

General. Eastern Shore has firm contracts with three major interstate pipelines, Transcontinental Gas Pipe Line Corporation ("Transco"), Columbia Gas Transmission Corporation ("Columbia") and Columbia Gulf Transmission Corporation ("Gulf"), all of which are open access pipelines.

Eastern Shore's contracts with Transco include: (a) firm transportation capacity of 22,900 Mcf per day, which expires in 2005; (b) firm transportation capacity of 500 Mcf per day for December through February, which expires in 2006; (c) three firm bundled storage services providing a peak day entitlement of 7,046 Mcf and a total capacity of 278,264 Mcf; and (d) two unbundled storage services with a total capacity of 432,663 Mcf.

Eastern Shore's contracts with Columbia include: (a) firm transportation capacity of 1,481 Mcf per day, which expires in 2004; (b) firm transportation capacity of 1,971 Mcf per day, which commences in 1997 and expires in 2017; (c) firm transportation capacity of 869 Mcf per day, which commences in 1998 and expires in 2018; (d) firm transportation capacity of 869 Mcf per day, which commences in 1999 and expires 2019; and (e) firm transportation capacity of 192 Mcf per day for April through August, which expires in 2003. Eastern Shore's contracts with Columbia also include: (a) firm storage service providing a peak day entitlement of 10,525 Mcf and a total capacity of 509,954 Mcf, which expires in 2004; (b) firm storage service providing a peak day entitlement of 1,150 Mcf and a total capacity of 103,459 Mcf, which commences in 1997 and expires in 2017; (c) firm storage service providing a peak day entitlement of 563 Mcf and a total capacity of 50,686 Mcf, which commences in 1998 and expires in 2018; and (d) firm storage service providing a peak day entitlement of 563 Mcf and a total capacity of 50,686 Mcf, which commences in 1999 and expires in 2019.

Eastern Shore's contract with Gulf is for firm transportation of 1,510 Mcf per day, which also expires in 2004.

Eastern Shore currently has contracts for the purchase of firm natural gas supplies with five reputable suppliers. These five supply contracts provide a maximum firm daily entitlement of 20,469 Mcf, which is transported by both Transco and Columbia under Eastern Shore's firm transportation contracts. The gas purchase contracts have various expiration dates.

*Adequacy of Gas Supply.* Eastern Shore's firm natural gas obligations to its customers, including Chesapeake's Delaware and Maryland utility divisions, are 40,237 Mcf for peak days and 9,180,203 Mcf on an annual basis. Eastern Shore's maximum daily firm transportation capacity on the Transco and Columbia systems is 42,452 Mcf per day. Currently, Eastern Shore's firm daily peak supply is 38,540 Mcf and its total annual firm supply is 6,032,665 Mcf. This is equivalent to 96% of Eastern Shore's firm daily demand and approximately 66% of its annual firm demand being satisfied by firm supply sources. To meet the difference between firm supply and firm demand, Eastern Shore obtains gas supply on the "spot market" from various other suppliers which is transported by Transco and/or Columbia and sold to Eastern Shore's customers as needed. The Company believes that Eastern Shore's available firm and "spot market" supply is ample to meet the anticipated needs of Eastern Shore's customers.

There was no curtailment of firm gas supply to Eastern Shore in 1996, nor does Eastern Shore anticipate any such curtailment during 1997.

#### *Competition*

*Competition with Alternative Fuels.* Historically, the Company's natural gas operations have successfully competed with other forms of energy such as electricity, oil and propane. The principal consideration in the competition between the Company and suppliers of other sources of energy is price and, to a lesser extent, accessibility. All of the Company's divisions have the capability of adjusting their interruptible rates to compete with alternative fuels.

The Company has several large volume industrial customers that have the capacity to use fuel oil as an alternative to natural gas. When oil prices decline, some of Chesapeake's natural gas distribution and transmission interruptible customers convert to oil to satisfy their fuel requirements. Lower levels in interruptible sales occur when oil prices remain depressed relative to the price of natural gas. However, oil prices as well as the prices of other fuels, are subject to change at any time for a variety of reasons; therefore, there is always uncertainty in the continuing competition among natural gas and other fuels. In order to address this uncertainty, the Company uses flexible pricing arrangements on both the supply and sales side of its business to maximize sales volumes.

To a lesser extent than price, availability of equipment and operational efficiency are also factors in competition among fuels, primarily in residential and commercial settings. Heating, water heating and other domestic or commercial equipment is generally designed for a particular energy source, and especially with respect to heating equipment, the cost of conversion is a dis-incentive for individuals and businesses to change their energy source.

*Competition within the Natural Gas Industry.* FERC Order 636 enables all natural gas suppliers to compete for customers on an equal footing. Under this open access environment, interstate pipeline companies have unbundled the traditional components of their service — gas gathering, transportation and storage from the sale of the commodity. If they choose to be a merchant of gas, they must form a separate marketing operation independent of their pipeline operations. Hence, gas marketers have developed as a viable option for many companies because they are providing expertise in gas purchasing along with collective purchasing capabilities which, when combined, may reduce end-user cost.

Currently, Eastern Shore is not an open access pipeline and is permitted to transport gas for only two of its existing customers. Thus, most of Eastern Shore's customers, including Chesapeake's Maryland and Delaware utility divisions, and, in turn, customers of these divisions, do not have the capability of directly contracting for alternative sources of gas supply and have Eastern Shore transport the gas to them. In December 1995, Eastern

Shore applied to the FERC for a blanket certificate authorizing open access transportation service on its pipeline system (see open access plan filing below). The implementation of open access transportation service, expected to occur during 1997, will provide all of Eastern Shore's customers with the opportunity to transport gas over its system at FERC regulated rates. For further discussion, see "Open Access Plan Filing" and Management Discussion and Analysis of financial condition and results of operations.

### ***Rates and Regulation***

***General.*** Eastern Shore is subject to regulation by the FERC as an interstate pipeline and the Delaware Public Service Commission ("Commission") as a supplier of gas to industrial customers in the state of Delaware. The FERC regulates the provision of service, terms and conditions of service, and the rates and fees Eastern Shore can charge its transportation and sale for resale customers. In addition, the FERC regulates the rates Eastern Shore is charged for transportation and transmission line capacity or services provided by Transco and Columbia. Eastern Shore's direct sales rates to industrial customers are currently not regulated. The rates for such sales are established by contracts negotiated between Eastern Shore and each industrial customer.

After Eastern Shore becomes an open access pipeline, the FERC will have sole regulatory authority over Eastern Shore. Accordingly, the Delaware Public Service Commission will cease having any regulatory authority over Eastern Shore.

The rates for Eastern Shore's "sale for resale" customers (i.e., sales to its utility customers) are subject to a purchased gas adjustment clause. Eastern Shore's firm industrial contracts generally include tracking provisions that permit automatic adjustment for the full amount of increases or decreases in Eastern Shore's suppliers' firm rates.

### ***Regulatory Proceedings***

***FERC PGA.*** On May 19, 1994, the FERC issued an Order directing Eastern Shore to refund, with interest, what the FERC characterized as overcharges from November 1, 1992 to the current billing month. The May 19, 1994 Order also directed Eastern Shore to file a report showing how the refund was calculated, and revised tariff language clarifying the purchased gas adjustment provisions in its tariff.

On August 17, 1995, the FERC issued an Order approving an Offer of Settlement submitted by Eastern Shore. The Order approved a change in Eastern Shore's PGA methodology retroactive to June 1, 1994, which will result in a rate reduction of approximately \$234,000 per year. The estimated liability that the Company had accrued for the potential refund was significantly greater than the rate reduction ordered. Accordingly, Eastern Shore reversed a large portion of the liability that it had accrued. This reversal contributed \$1,385,000 to pre-tax earnings or \$833,000 to after-tax earnings during the third quarter of 1995.

In connection with the FERC Order, Eastern Shore applied in December 1995, to the FERC for a blanket certificate authorizing open access transportation service on its pipeline system. For further discussion see "Open Access Plan Filing" below.

***Delaware City Compressor Station Filing.*** On December 5, 1995, Eastern Shore filed an application before the FERC pursuant to Sections 7(b) and (c) of the Natural Gas Act for a certificate of public convenience and necessity authorizing Eastern Shore to: (1) construct and operate a 2,170 horsepower compressor station in Delaware City, New Castle County, Delaware on a portion of its existing pipeline system known as the "Hockessin Line", such new station to be known as the "Delaware City Compressor Station"; (2) construct and operate slightly less than one mile of 16-inch pipeline in Delaware City, New Castle County, Delaware to tie the suction side of the proposed Delaware City Compressor Station into the Hockessin Line; and (3) increase

the maximum allowable operating pressure ("MAOP") from 500 PSIG to 590 PSIG on 28.7 miles of Eastern Shore's pipeline from Eastern Shore's existing Bridgeville Compressor Station in Bridgeville, Sussex County, Delaware to its terminus in Salisbury, Wicomico County, Maryland.

The compressor facility and associated piping are needed to stabilize capacity on Eastern Shore's system as a result of steadily declining inlet pressures at the Hockessin interconnect with Transcontinental Gas Pipe Line Corporation. Construction of the facilities started during the second half of 1996. The proposed in-service date of the facilities is March 19, 1997. Eastern Shore estimates the total cost of the compressor facilities to be \$6.9 million.

The proposed facilities would also enable Eastern Shore to provide additional firm services to several of its customers who have executed agreements for the additional firm service for terms of 10 and 20 years. Eastern Shore also requested authorization to abandon 100 Mcf per day of firm sales service to one of its direct sales customers.

On September 28, 1996 the FERC issued its Final Order, which:

- authorized Eastern Shore to construct and operate the facilities requested in its application;
- authorized Eastern Shore to roll-in the cost of the facilities into its existing rates if the revenues from the increase in services exceed the cost associated with the expansion portion of the project;
- denied Eastern Shore the authority to increase the level of sales and storage service it provides its customers until it completes its restructuring in its open access proceeding; and
- authorized Eastern Shore to abandon the 100 Mcf per day of firm sale service, to one of its direct sale customers.

Rate Case Filing. On October 15, 1996 Eastern Shore filed for a general rate increase with the FERC. The filing proposed an increase in Eastern Shore's jurisdictional rates that would generate additional annual operating revenue of approximately \$1,445,000. Eastern Shore also stated in the filing that it intended to use the cost-of-service submitted in the general rate increase filing to develop rates in the pending Open Access Docket. The Commission, by letter order dated November 14, 1995, suspended the tariff sheets for the maximum five-month period as allowed by Commission regulation.

On March 4, 1997, a pre-hearing conference was conducted at FERC's office to establish a procedural schedule to establish a preliminary list of contested issues and to advise the Presiding Judge of any matters which need to be resolved. Hearings are tentatively scheduled to start in 1997.

Open Access Filing. On December 29, 1995, Eastern Shore filed its abbreviated application for a blanket certificate of public convenience and necessity authorizing the transportation of natural gas on behalf of others.

Eastern Shore proposed to unbundle the sales and storage services it currently provides. Customers receiving firm sales and storage services on Eastern Shore (the "Converting Customers") would receive entitlements to firm transportation service on Eastern Shore's pipeline in a quantity equivalent to their current service rights. Eastern Shore proposed to retain some of its pipeline entitlements and storage capacity for operational issues and to facilitate "no-notice" (no prior notification required to receive service) transportation service on its pipeline system. Eastern Shore will release or assign to the remaining Converting Customers the firm transportation capacity, including contract storage, it holds on its upstream pipelines so that the Converting Customers can become direct customers of such upstream pipelines. Converting Customers who previously received bundled sales service having no-notice characteristics will have the right to elect no-notice firm transportation service.

With respect to cost classification, allocation and rate design, Eastern Shore proposes to implement straight fixed variable ("SFV") cost classification. In order to accomplish a change from its current modified fixed variable ("MFV") rate design, Eastern Shore made a Section 4 rate filing with the FERC on January 17, 1997.

During 1996, numerous technical conferences were held at the FERC's office in Washington, D.C. to review the proposed Open Access tariff. On December 2, 1996, Eastern Shore filed a revised Pro-forma Open Access tariff. A technical conference was conducted on December 12, 1996 to discuss Eastern Shore's filing. As a result of the technical conference, Eastern Shore formally filed a revised Open Access tariff including rate schedules on January 17, 1997. The filing included a proposed effective date, the latter of May 1, 1997 or the effective date of the Open Access blanket certificate. Since January 17, 1997, several parties have filed comments. Eastern Shore filed reply comments and a technical conference was convened on March 4, 1997. As a result of the March 4 technical conference, Eastern Shore will be submitting a revised proposal to the parties in an effort to gain consensus on the major issues. While at this time it is impossible to predict the exact timing of the implementation of Open Access on Eastern Shore's system, significant progress has been made, and management expects that implementation will occur sometime during the second or third quarter of 1997.

*(i) (b) Natural Gas Distribution*

Chesapeake distributes natural gas to approximately 34,700 residential, commercial and industrial customers in southern Delaware, the Salisbury and Cambridge, Maryland areas on Maryland's Eastern Shore, and Central Florida. These activities are conducted through three utility divisions, consisting of one division in Delaware, one division in Maryland and one division in Florida. In 1993, the Company started natural gas supply management services in the state of Florida under the name of Peninsula Energy Services Company ("PESCO").

Delaware and Maryland. The Delaware and Maryland divisions serve approximately 26,160 customers, of which approximately 26,050 are residential and commercial customers purchasing gas primarily for heating purposes. Residential and commercial customers account for approximately 69% of the volume delivered by the divisions, and 78% of the divisions' revenue, on an annual basis. The divisions' industrial customers purchase gas, primarily on an interruptible basis, for a variety of manufacturing, agricultural and other uses. Most of Chesapeake's customer growth in these divisions comes from new residential construction utilizing gas heating equipment.

Florida. The Florida division distributes natural gas to approximately 8,450 residential and commercial and 87 industrial customers in Polk, Osceola and Hillsborough Counties. Currently 42 of the division's industrial customers, which are engaged primarily in the citrus and phosphate industries and electric cogeneration, and purchase and transport gas on a firm and interruptible basis, account for approximately 90% of the volume delivered by the Florida division, and 62% of the division's natural gas sales and transportation revenues, on an annual basis. The Company's Florida division also provides natural gas supply services to compete in the open access environment. Currently, nineteen customers receive such management service which generated operating income of \$209,000 in 1996.

*Natural Gas Supply*

Delaware and Maryland. Chesapeake's Delaware and Maryland utility divisions receive all of their gas supply requirements from Eastern Shore. The divisions purchase most of this gas under contracts with Eastern Shore which extend through November 1, 2000. The contracts provide for the purchase of 15,629 firm Mcf daily (up to a maximum of 5,704,585 Mcf annually). The divisions have additional firm supplies available under contract with Eastern Shore for peak demand periods occurring during the winter heating season. These

contracts, which are renewable on a year-to-year basis, provide for the purchase of up to 450 Mcf daily (up to a maximum of 13,500 Mcf annually) of peaking service. In addition, the divisions have contracted with Eastern Shore for firm and interruptible storage capacity. On days when gas volumes available to the divisions from Eastern Shore are greater than their requirements, gas is injected into storage and is then available for withdrawal to meet heavier winter loads. These storage contracts also permit the utility divisions to purchase lower cost gas during the off-peak summer season. Effective July 1, 1996, the storage capacity under contract with Eastern Shore totaled 820,220 Mcf, with a firm peak daily withdrawal entitlement of 14,606 Mcf. On those days when requirements exceed these contract pipeline supplies, the divisions have propane-air injection facilities for peak shaving.

Eastern Shore has no authority to transport natural gas purchased from a third party for the Delaware and Maryland divisions currently; however, while Chesapeake's divisions have no direct access to "spot market" gas, they benefit from Eastern Shore's ability to obtain "spot market" gas and the resulting reductions in Eastern Shore's rates. After Eastern Shore becomes an open access pipeline the Delaware and Maryland divisions will assume the responsibility of purchasing their natural gas requirements. The two divisions could contract with a natural gas supply management company or handle the process internally.

Florida. The Florida division receives transportation service from Florida Gas Transmission Company ("FGT"), a major interstate pipeline. Chesapeake has contracts with FGT for: (a) daily firm transportation capacity of 20,523 dekatherms in May through September, 27,105 dekatherms in October, and 26,919 dekatherms in November through April under FGT's firm transportation service (FTS-1) rate schedule; (b) daily firm transportation capacity of 5,100 dekatherms in May through October, and 8,100 dekatherms in November through April under FGT's firm transportation service (FTS-2) rate schedule; (c) preferred interruptible transportation service up to 2,300,000 dekatherms annually under FGT's preferred transportation service (PTS-1) rate schedule; and (d) daily interruptible transportation capacity of 20,000 dekatherms under FGT's interruptible transportation services (ITS-1) rate schedule. The firm transportation contract (FTS-1) expires on August 1, 2000 with the Company retaining a unilateral right to extend the term for an additional ten years. After the expiration of the primary or secondary term, Chesapeake has the right to first refuse to match the terms of any competing bids for the capacity. The firm transportation contract (FTS-2) expires on March 1, 2015. The preferred interruptible contract expires on the earlier of: (a) the effective date of FGT's first rate case which includes costs for phase III expansion or (b) August 1, 1995, and/or (c) August 1 of any subsequent year, provided that FGT or Chesapeake gives to the other at least one hundred eighty (180) days written notice prior to such August 1. The interruptible transportation contract is effective until August 1, 2010 and month to month thereafter unless canceled by either party with thirty days notice.

The Florida division currently receives its gas supply from various suppliers. Some supply is bought on the spot market and some is bought under the terms of two firm supply contacts with MG National Gas Corp. and Hadson Gas Systems, Inc.

Having restructured its arrangements with FGT, Chesapeake believes it is well positioned to meet the continuing needs of its customers with secure and cost effective gas supplies.

Adequacy of Gas Supply. The Company believes that Eastern Shore's available firm and interruptible supply is ample to meet the anticipated needs of the Company's Delaware and Maryland natural gas distribution divisions. Availability of gas supply to the Florida division is also expected to be adequate under existing arrangements. Moreover, additional supply sources have become available as a result of FGT becoming an open access pipeline.

*Competition within the Natural Gas Industry.* Historically, Chesapeake's Florida division has been supplied solely by FGT. In 1990, FGT became an open access pipeline. The Florida division's large industrial customers now have the option of remaining with the Florida division for gas supply or obtaining alternative supplies from gas marketers or other suppliers. These conditions have increased competition between Chesapeake's Florida division, gas marketers and other natural gas providers for industrial customers in Central Florida.

Eastern Shore has an open access filing and associated rate filing pending before the FERC. When Eastern Shore becomes an open access pipeline, certain customers in Chesapeake's Delaware and Maryland distribution divisions will be able to purchase gas from third party gas suppliers in accordance with regulations established through the respective state commissions.

#### ***Rates and Regulation***

*General.* Chesapeake's natural gas distribution divisions are subject to regulation by the Delaware, Maryland and Florida Public Service Commissions with respect to various aspects of the Company's business, including the rates for sales to all of their customers in each jurisdiction. All of Chesapeake's firm distribution rates are subject to purchased gas adjustment clauses, which match revenues with gas costs and normally allow eventual full recovery of gas costs. Adjustments under these clauses require periodic filings and hearings with the relevant regulatory authority, but do not require a general rate proceeding. Rates on interruptible sales by the Florida division are also subject to purchased gas adjustment clauses.

Management monitors the rate of return in each jurisdiction in order to ensure the timely filing of rate adjustment applications.

#### ***Regulatory Proceedings***

*Maryland.* On July 31, 1995, Chesapeake's Maryland division filed an application with the Maryland Public Service Commission ("MPSC") requesting a rate increase of \$1,426,711 or 17.09%. The two largest components of the increase were attributable to environmental costs and a new customer information system, implemented in 1995. The request included a return on equity of 13%.

On November 30, 1995, the MPSC issued an order approving a settlement proposal of a \$975,000 increase in annual base rates effective for gas provided on or after December 1, 1995. As required in the settlement of the rate case, the Company filed a cost of service study with the MPSC on June 28, 1996. The purpose of a cost of service study is to allocate revenue among customer or rate classifications. The filing also included proposals for: restructuring sales services that more closely reflect the cost of serving commercial and industrial customers, the unbundling of gas costs from distribution system costs, revisions to sharing of interruptible margins between firm ratepayers and the Company and new services that would allow customers using more than 30,000 Ccf of gas per year to purchase gas from suppliers other than the Company.

After negotiations with MPSC staff and other interested parties, a settlement was reached on most sales service issues and a proposed order was issued by the Hearing Examiner on March 7, 1997. Commission action on the proposed order is still pending. The settlement includes:

1. Class revenue requirements and restructured sales services which provide for separate firm commercial and industrial rate schedules for general service, medium volume, large volume and high load factor customer groups;
2. Unbundling of gas costs from distribution charges;

3. A new gas cost recovery mechanism, which utilizes a projected period under which the fixed cost portion of the gas rate will be forecasted on an annual basis and the commodity cost portion of the gas rate will be estimated quarterly, based on projected market prices; and
4. Interruptible margins will continue to be shared, 90% to customers and 10% to the Company, but distribution costs incurred for incremental load additions can be recovered with carrying charges utilizing 100% of the incremental margin if the payback period is within three years.

At the request of MPSC staff, consideration of the new transportation services has been postponed because Eastern Shore's open access filing is still pending before the FERC. It is expected that these services will be addressed in the spring of 1997.

Delaware. On April 4, 1995, Chesapeake's Delaware division filed an application with the Delaware Public Service Commission ("DPSC") requesting a rate increase of \$2,751,000 or 14% over current rates. The largest component, representing a third of the total requested increase, is attributable to projected costs associated with the remediation proposed by the Environmental Protection Agency ("EPA") of the site of a former coal gas manufacturing plant operated in Dover, Delaware. The Company and the DPSC agreed to separate the environmental recovery from the rate increase so each could be addressed individually.

On December 20, 1995, the DPSC approved an order authorizing a \$900,000 increase to base rates effective January 1, 1996. The Company had interim rates subject to refund in effect starting June 3, 1995 to collect \$1.0 million on an annualized basis. A refund of \$42,000 was calculated and used to offset environmental costs incurred.

Also on December 20, 1995, the DPSC approved a recovery of environmental costs associated with the Dover Gas Light Site by means of a rider (supplement) to base rates. The DPSC approved a rider effective January 1, 1996 to recover over five years all unrecovered environmental costs through September 30, 1995 offset by the deferred tax benefit of these costs. The deferred tax benefit equals the projected cashflow savings realized by the Company in connection with a reduced income tax liability due to the possibility of accelerated deduction allowed on certain environmental costs when incurred. Each year, the rider rate will be calculated based on the amortization of expenses for previous years. The advantage of the environmental rider is that it is not necessary to file a rate case every year to recover expenses.

On December 15, 1995, Chesapeake's Delaware division filed its rate design proposal with the DPSC to initiate Phase II of this proceeding. The principal objective of the filing was to prepare the Company for an increasingly competitive environment anticipated in the near future when Eastern Shore becomes an open access pipeline. This initial filing proposed new rate schedules for commercial and industrial sales service, individual pricing for interruptible negotiated contract rates, a modified purchased gas cost recovery mechanism and a natural gas vehicle tariff.

On May 15, 1996, the Delaware division filed its proposal relating to transportation and balancing services with the DPSC which proposed that transportation of customer owned gas be available to all commercial and industrial customers with annual consumption over 30,000 Ccf per year.

A tentative settlement proposal which was submitted to the DPSC Hearing Examiner on November 22, 1996. On January 23, 1997 the DPSC Hearing Examiner issued his proposed findings and recommendations supporting the parties settlement proposal for final DPSC approval. On February 4, 1997 the DPSC approved an order authorizing new service offerings and rate design for services rendered on and after March 1, 1997.



The approved changes include:

1. Restructured sales services which provide commercial and industrial customers with various service classifications such as general service, medium volume, large volume and high load factor services;
2. A modified purchased gas cost recovery mechanism which takes into consideration the unbundling of gas costs from distribution charges as well as charging certain firm service classifications different gas cost rates based on a customers' load factor;
3. The implementation of a mechanism for sharing interruptible, capacity release and off-system sales margins between firm sales customers and the Company, with changing margin sharing percentages based on the level of total margin; and
4. Provision for transportation and balancing services for commercial and industrial customers with annual consumption over 30,000 Ccf per year to transport customer-owned gas on the Company's distribution system.

Florida. On September 28, 1995, the Florida Public Service Commission issued an order finalizing the Florida division's 1994 amount of overearnings. The division was found to have exceeded its allowed rate of return equity ceiling of 12% by \$62,000. As a result of an agreement reached February 6, 1995, the excess earnings were deferred until 1995. The same agreement capped the Florida Division's 1995 return on equity at 12% plus or minus the result of subtracting the average yield of 30-year U.S. Treasury bonds for the period of October, November and December, 1994 from the average yield of 30-year U.S. Treasury bonds for October, November and December 1995, not to exceed 50 basis points in either direction. As a result, the Florida Division's return on equity for 1995 was lowered to a midpoint of 10.5% for determining the level of overearnings. For 1995, the Florida Division was found to have exceeded its allowed rate of return equity ceiling of 11.5% by \$230,000. On January 21, 1997 the Florida Public Service Commission voted to allow the division to apply the total overearnings for 1994 and 1995 in the amount of \$292,000 to its environmental reserve. The Commission Order affirming this decision was issued in February, 1997.

*(i) (c) Propane Distribution*

Chesapeake's propane distribution group consists of Sharp Energy, Inc. ("Sharp Energy"), a wholly owned subsidiary of Chesapeake, and its wholly owned subsidiary, Sharpgas, Inc. ("Sharpgas").

On March 6, 1997, Chesapeake acquired all of the outstanding shares of Tri-County Gas Company, Inc. ("Tri-County"), a family-owned and operated propane distribution business located in Salisbury and Pocomoke, Maryland. The combined operations of the Company and Tri-County served approximately 32,000 propane customers on the Delmarva Peninsula and delivered approximately 30-million retail and wholesale gallons of propane during 1996.

Sharpgas stores and distributes propane to approximately 23,100 customers on the Delmarva Peninsula. The propane distribution business is affected by many factors such as seasonality, the absence of price regulation and competition among local providers.

Propane is a form of liquefied petroleum gas which is typically extracted from natural gas or separated during the crude oil refining process. Although propane is gaseous at normal pressures, it is easily compressed into liquid form for storage and transportation. Propane is a clean-burning fuel, gaining increased recognition for its environmental superiority, safety, efficiency, transportability and ease of use relative to alternative forms of energy.

Propane is sold primarily in suburban and rural areas which are not served by natural gas pipelines. Demand is typically much higher in the winter months and is significantly affected by seasonal variations, particularly the relative severity of winter temperatures, because of its use in residential and commercial heating.

The Company purchases propane primarily from suppliers, including major domestic oil companies and independent producers of gas liquids and oil. Supplies of propane from these and other sources are readily available for purchase by the Company. Supply contracts generally include minimum (not subject to a take-or-pay premiums) and maximum purchase provisions.

The Company uses trucks and railroad cars to transport propane from refineries, natural gas processing plants or pipeline terminals to the Company's bulk storage facilities. From these facilities, propane is delivered in portable cylinders or by "bobtail" trucks, owned and operated by the Company, to tanks located at the customer's premises.

Sharpgas competes with several other propane distributors in its service territories, primarily on the basis of service and price, emphasizing reliability of service and responsiveness. Competition is generally local because distributors located in close proximity to customers incur lower costs of providing service.

Propane competes with both fuel oil and electricity as an energy source. Propane competes against fuel oil based upon cleanliness and its environmental advantages. Propane is also typically less expensive than both fuel oil and electricity based on equivalent BTU value. Because natural gas has historically been less expensive than propane, propane is generally not distributed in geographic areas serviced by natural gas pipeline or distribution systems.

The Company's propane distribution activities are not subject to any federal or state pricing regulation. Transport operations are subject to regulations concerning the transportation of hazardous materials promulgated under the Federal Motor Carrier Safety Act, which is administered by the United States Department of Transportation and enforced by the various states in which such operations take place. Propane distribution operations are also subject to state safety regulations relating to "hook-up" and placement of propane tanks.

The Company's propane operations are subject to all operating hazards normally incident to the handling, storage and transportation of combustible liquids, such as the risk of personal injury and property damage caused by fire. The Company carries general liability insurance in the amount of \$35,000,000 per occurrence, but there is no assurance that such insurance will be adequate.

*(i) (d) Advanced Information Services*

Chesapeake's advanced information services segment is comprised of United Systems, Inc. ("USI") and Capital Data Systems, Inc. ("CDS"), both wholly owned subsidiaries of the Company. CDS provided programming support for application software, until the first quarter of 1997, at which time they disposed of substantially all of their assets.

USI is an Atlanta-based company that primarily provides support for users of PROGRESS®, a fourth generation computer language and Relational Database Management System. USI offers consulting, training, software development "tools" and customer software development for its client base, which includes many large domestic and international corporations.

The advanced information services businesses face significant competition from a number of larger competitors having substantially greater resources available to them than the Company. In addition, changes in the advanced information services businesses are occurring rapidly, which could adversely impact the markets for the Company's products and services.

*(i) (e) Other Subsidiaries*

Skipjack, Inc. ("Skipjack") and Chesapeake Investment Company ("Chesapeake Investment"), are wholly owned subsidiaries of Chesapeake Service Company. Skipjack owns and leases to affiliates, two office buildings in Dover, Delaware. Chesapeake Investment is a Delaware affiliated investment company.

On March 6, 1997, in connection with the acquisition of Tri-County, the Company acquired Eastern Shore Real Estate, Inc. ("ESR"), which will become a wholly owned subsidiary of Chesapeake Service Company. ESR owns and leases office buildings to affiliates and external companies.

*(ii) Seasonal Nature of Business*

Revenues from the Company's residential and commercial natural gas sales and from its propane distribution activities are affected by seasonal variations, since the majority of these sales are to customers using the fuels for heating purposes. Revenues from these customers are accordingly affected by the mildness or severity of the heating season.

*(iii) Capital Budget*

The Company's current capital budget for 1997 contemplates expenditures totaling approximately \$18.9 million. The total includes approximately \$8.5 million for Chesapeake's natural gas distribution divisions, consisting mainly of extensions to and replacements of the distribution facilities and related equipment; \$4.5 million for natural gas transmission operations, providing principally for improvements to the pipeline system and for finishing construction of a compressor station in Delaware City, \$3.8 million for environmental related expenditures, \$1.8 million for propane distribution, principally for the purchase of storage facilities, additional tanks and the construction of a new operation center in Pocomoke, Maryland; \$150,000 for computer hardware, furniture and fixtures for the Company's advanced information services group; along with \$150,000 for general plant. These capital requirements are expected to be financed by cash flow provided by the Company's operating activities short-term borrowing, and the issuance of long-term debt, common equity or a combination thereof.

*(iv) Employees*

The Company has 338 employees including 131 natural gas distribution employees, 18 natural gas transmission employees, 97 propane distribution employees and 49 advanced information services employees. The remaining 43 employees are considered general and administrative and include officers of the Company and treasury, accounting, data processing, planning, human resources and other administrative personnel. The acquisition of Tri-County will add approximately 43 employees to the total number of employees of the Company.

## **Item 2. Properties**

### **(a) General**

The Company owns offices and operates buildings in Salisbury, Cambridge, and Princess Anne, Maryland; Dover, Seaford, Laurel and Georgetown, Delaware; and Winter Haven, Florida, and rents office space in Dover, Delaware; Plant City, Florida; Chincoteague and Belle Haven, Virginia; Easton and Pocomoke, Maryland; and Atlanta, Georgia. In general, the properties of the Company are adequate for the uses for which they are employed. Capacity and utilization of the Company's facilities can vary significantly due to the seasonal nature of the natural gas and propane distribution businesses.

### **(b) Natural Gas Distribution**

Chesapeake owns over 514 miles of natural gas distribution mains (together with related service lines, meters and regulators) located in its Delaware and Maryland service areas, and 459 miles of such mains (and related equipment) in its Central Florida service areas. Chesapeake also owns facilities in Delaware and Maryland for propane-air injection during periods of peak demand.

A portion of the properties constituting Chesapeake's distribution system are encumbered pursuant to Chesapeake's First Mortgage Bonds.

### **(c) Natural Gas Transmission**

Eastern Shore owns approximately 271 miles of transmission lines extending from Parkesburg, Pennsylvania to Salisbury, Maryland. Eastern Shore also owns three compressor stations located in Delaware City, Delaware, Daleville, Pennsylvania and Bridgeville, Delaware. The Delaware City compressor station is currently under construction with a proposed in-service date of March 19, 1997. The Delaware City compressor facility and associated piping are needed to stabilize capacity on Eastern Shore's system as a result of steadily declining inlet pressures at the Hockessin interconnect with Transcontinental Gas Pipe Line Corporation. The Daleville station is utilized to increase Columbia supply pressures to match Transco supply pressures, and to increase Eastern Shore's pressures in order to serve Eastern Shore's firm customers' demands, including demands from Chesapeake's Delaware and Maryland divisions. The Bridgeville station is being used to provide increased pressures required to meet the demands on the system.

### **(d) Propane Distribution**

Sharpgas owns bulk propane storage facilities with an aggregate capacity of 1,482,000 gallons at 26 plant facilities in Delaware, Maryland and Virginia, located on real estate it either owns or leases.

## **Item 3. Legal Proceedings**

The Company and its subsidiaries are 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 of the Company.

## Environmental

### (a) Dover Gas Light Site

In 1984, the State of Delaware notified the Company that a parcel of land it purchased in 1949 from Dover Gas Light Company, a predecessor gas company, contains hazardous substances. The State also asserted that the Company is responsible for any clean-up and prospective environmental monitoring of the site. The Delaware Department of Natural Resources and Environmental Control ("DNREC") investigated the site and surroundings, finding coal tar residue and some ground-water contamination.

In October 1989, the Environmental Protection Agency Region III ("EPA") listed the Dover Site on the National Priorities List under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA" or "Superfund"). At that time under CERCLA, both the State of Delaware and the Company were named as potentially responsible parties ("PRP") for clean-up of the site.

The EPA issued the site Record of Decision ("ROD") dated August 16, 1994. The remedial action selected by the EPA in the ROD addresses the ground-water contamination with a combination of hydraulic containment and natural attenuation. Remediation selected for the soil at the site is to meet stringent cleanup standards for the first two feet of soil and less stringent standards for the soil below two feet. The ROD estimates the costs of selected remediation of ground-water and soil at \$2.7 million and \$3.3 million, respectively.

On November 18, 1994, EPA issued a "Special Notice Letter" (the "Letter") to Chesapeake and three other PRPs. The Letter includes, inter alia, (1) a demand for payment by the PRPs of EPA's past costs (estimated to be approximately \$300,000) and future costs incurred overseeing Site work; (2) notice of EPA's commencement of a 60 day moratorium on certain EPA response activities at the Site; (3) a request by EPA that Chesapeake and the other PRPs submit a "good faith proposal" to conduct or finance the work identified in the ROD; and (4) proposed consent orders by which Chesapeake and other parties may agree to perform the good faith proposal.

In January 1995, Chesapeake submitted to the EPA a good faith proposal to perform a substantial portion of the work set forth in the ROD, which was subsequently rejected. The Company and the EPA each attempted to secure voluntary performance of part of the remediation by other parties. These parties include the State of Delaware, which is the owner of the property and was identified in the ROD as a PRP, and a business identified in the ROD as a PRP for having contributed to ground-water contamination.

On May 17, 1995, EPA issued an order to the Company under section 106 of CERCLA (the "Order"), which requires the Company to fund or implement the ROD. The Order was also issued to General Public Utilities Corporation, Inc. ("GPU"), which both EPA and the Company believe is liable under CERCLA. Other PRPs such as the State of Delaware were not ordered to perform the ROD. EPA may seek judicial enforcement of its Order, as well as significant financial penalties for failure to comply. Although notifying EPA of objections to the Order, the Company agreed to comply. GPU informed EPA that it does not intend to comply with the Order.

On March 6, 1995, the Company commenced litigation against the State of Delaware for contribution to the remedial costs being incurred to carry out the ROD. In December of 1995, this case was dismissed without prejudice based on a settlement agreement between the parties (the "Settlement"). Under the Settlement, the State agreed to support the Company's proposal to reduce the soil remedy for the site, described below, to contribute \$600,000 toward the cost of implementing the ROD, and to reimburse the EPA for \$400,000 in oversight costs. The Settlement is contingent upon a formal settlement agreement between EPA and the State of Delaware being reached.

within the next two years. Upon satisfaction of all conditions of the Settlement, the litigation will be dismissed with prejudice.

On July 7, 1995, the Company submitted to EPA a study proposing to reduce the level and cost of soil remediation from that identified in the ROD. Although this proposal was supported by the State of Delaware, as required by the Settlement, it was rejected by the EPA on January 30, 1996.

On June 25, 1996, the Company initiated litigation against GPU for contribution to the remedial costs incurred by Chesapeake in connection with complying with the ROD. At this time, management cannot predict the outcome of the litigation or the amount, if any, of proceeds to be received.

In July 1996, the Company commenced the design phase of the ROD, on-site pre-design and investigation. A pre-design investigation report ("the report") was filed in October 1996 with the EPA. The report, which requires EPA approval, will provide up to date status on the site, which the EPA will use to determine if the remedial design selected in the ROD is still the appropriate remedy.

The Company is currently engaged in investigations related to additional parties who may be PRPs. Based upon these investigations, the Company will consider suit against other PRPs. The Company expects continued negotiations with PRPs in an attempt to resolve these matters.

In the third quarter of 1994, the Company increased its accrued liability recorded with respect to the Dover Site to \$6.0 million. This amount reflects the EPA's estimate, as stated in the ROD for remediation of the site according to the ROD. The recorded liability may be adjusted upward or downward as the design phase progresses and the Company obtains construction bids for performance of the work. The Company has also recorded a regulatory asset of \$6.0 million, corresponding to the recorded liability. Management believes that in addition to the \$600,000 expected to be contributed by the State of Delaware under the Settlement, the Company will be equitably entitled to contribution from other responsible parties for a portion of the expenses to be incurred in connection with the remedies selected in the ROD. Management also believes that the amounts not so contributed will be recoverable in the Company's rates.

As of December 31, 1996, the Company has incurred approximately \$4.2 million in costs relating to environmental testing and remedial action studies. In 1990, the Company entered into settlement agreements with a number of insurance companies resulting in proceeds to fund actual environmental costs incurred over a five to seven-year period beginning in 1990. In December 1995, the Delaware Public Service Commission, authorized recovery of all unrecovered environmental cost incurred by a means of a rider (supplement) to base rates, applicable to all firm service customers. The costs would be recovered through a five-year amortization offset by the deferred tax benefit associated with those environmental costs. The deferred tax benefit equals the projected cashflow savings realized by the Company in connection with a reduced income tax liability due to the possibility of accelerated deduction allowed on certain environmental costs when incurred. Each year a new rider rate will be calculated to become effective December 1. The rider rate will be based on the amortization of expenditures through September of the filing years plus amortization of expenses from previous years. The advantage of the rider is that it is not necessary to file a rate case every year to recover expenses incurred. As of December 31, 1996, the unamortized balance and amount of environment cost not included in the rider, effective January 1, 1997 was \$1,206,000 and \$191,000, respectively. With the rider mechanism established, it is management's opinion that these costs and any future cost, net of the deferred income tax benefit, will be recoverable in rates.

#### **(b) Salisbury Town Gas Light Site**

In cooperation with the Maryland Department of the Environment ("MDE"), the Company has completed an assessment of the Salisbury manufactured gas plant site. The assessment determined that there was localized contamination of ground-water. A remedial design report was submitted to MDE in November 1990 and included a proposal to monitor, pump and treat any contaminated ground-water on-site. Through negotiations with the MDE, the remedial action workplan was revised with final approval from MDE obtained in early 1995. The remediation process for ground-water was revised from pump-and-treat to Air Sparging and Soil-Vapor Extraction, resulting in a substantial reduction in overall costs. During 1996, the Company completed construction and began remediation procedures at the Salisbury site and will be reporting on an ongoing basis the remediation and monitoring results to the Maryland Department of the Environment.

The cost of remediation is estimated to range from \$140,000 to \$190,000 per year for operating expenses. Based on these estimated costs, the Company recorded both a liability and a deferred regulatory asset of \$650,088 on December 31, 1996, to cover the Company's projected remediation costs for this site. The liability payout for this site is expected to be over a five-year period. As of December 31, 1996, the Company has incurred approximately \$2.2 million for remedial actions and environmental studies and has charged such costs to accumulated depreciation. In January 1990, the Company entered into settlement agreements with a number of insurance companies resulting in proceeds to fund actual environmental costs incurred over a three to five-year period beginning in 1990. The final insurance proceeds were requested and received in 1992. In December 1995, the Maryland Public Service Commission approved recovery of all environmental cost incurred through September 30, 1995 less amounts previously amortized and insurance proceeds. The amount approved for a 10-year amortization was \$964,251. Of the \$2.2 million in costs reported above, approximately \$417,000 has not been recovered through insurance proceeds or received ratemaking treatment. It is management's opinion that these costs incurred and future costs incurred, if any, will be recoverable in rates.

#### **(c) Winter Haven Coal Gas Site**

The Company is currently conducting investigations of a site in Winter Haven, Florida, where the Company's predecessors manufactured coal gas earlier this century. A Contamination Assessment Report ("CAR") was submitted to the Florida Department of Environmental Protection ("FDEP") in July, 1990. The CAR contained the results of additional investigations of conditions at the site. These investigations confirmed limited soil and ground-water impacts to the site. In March 1991, FDEP directed the Company to conduct additional investigations on-site to fully delineate the vertical and horizontal extent of soil and ground-water impacts.

Additional contamination assessment activities were conducted at the site in late 1992 and early 1993. In March 1993, a Contamination Assessment Report Addendum ("CAR Addendum") was delivered to FDEP. The CAR Addendum concluded that soil and ground-water impacts have been adequately delineated as a result of the additional field work. The FDEP approved the CAR and CAR Addendum in March of 1994. The next step is a Risk Assessment ("RA") and a Feasibility Study ("FS") on the site. A draft of the RA and FS were filed with the FDEP during 1995; however, until the RA and FS are not complete until accepted as final by the FDEP. On May 10, 1996, CFGC transmitted to FDEP an Air Sparging and Soil Vapor Extraction Pilot Study Work Plan for FDEP's review and approval. The Work Plan described CFGC's proposal to undertake an Air Sparging and Soil Vapor Extraction pilot study to evaluate the effectiveness of air sparging as a groundwater remedy combined with soil vapor extraction at the Property. CFGC is currently awaiting FDEP's comments to the Work Plan. It is not possible to determine whether remedial action will be required by FDEP and, if so, the cost of such remediation.

The Company has spent approximately \$660,000, as of December 31, 1996, on these investigations, and expects to recover these expenses, as well as any future expenses, through base rates. These costs have been accounted for as charges to accumulated depreciation. The Company requested and received from the Florida Public Service Commission ("FPSC") approval to amortize through base rates \$359,659 of clean-up and removal costs incurred as of December 31, 1986. As of December 31, 1992, these costs were fully amortized. In January 1993, the Company received approval to recover through base rates approximately \$217,000 in additional costs related to the former manufactured gas plant. This amount represents recovery of \$173,000 of costs incurred from January 1987 through December 1992, as well as prospective recovery of estimated future costs which had not yet been incurred at that time. The FPSC has allowed for amortization of these costs over a three-year period and provided for rate base treatment for the unamortized balance. In a separate docket before the FPSC, the Company has requested and received approval to apply a refund of 1991 overearnings of approximately \$118,000 against the balance of unamortized environmental charges incurred as of December 31, 1992. As a result, these environmental charges were fully amortized as of June 1994. The FPSC issued an order in January 1997, applying a refund of \$292,000, pertaining to 1994 and 1995 overearnings, toward the balance of unamortized environmental charges. Of the \$660,000 in costs reported above, all costs have received ratemaking treatment. The FPSC has allowed the Company to continue to accrue for future environmental costs. At December 31, 1996, the Company has \$396,000 accrued. It is management's opinion that future costs, if any, will be recoverable in rates.

**(d) Smyrna Coal Gas Site**

On August 29, 1989 and August 4, 1993, representatives of DNREC conducted sampling on property owned by the Company in Smyrna, Delaware. This property is believed to be the location of a former manufactured gas plant. Analysis of the samples taken by DNREC show a limited area of soil contamination.

On November 2, 1993, DNREC advised the Company that it would require a remediation of the soil contamination under the state's Hazardous Substance Cleanup Act and submitted a draft Consent Decree to the Company for its review. The Company met with DNREC personnel in December 1993 to discuss the scope of any remediation of the site and, in January 1994, submitted a proposed workplan, together with comments on the proposed Consent Decree. The final Work Plan was submitted on September 27, 1994. DNREC has approved the Work Plan and the Consent Decree. Remediation based on the Work Plan was completed in 1995, at a cost of approximately \$263,000. In June 1996, the Company received the certificate of completion from DNREC. It is management's opinion that these costs will be recoverable in rates.

**Item 4. Submission of Matters to a Vote of Security Holders**

None

**Item 10. Executive Officers of the Registrant**

Information pertaining to the Executive Officers of the Company is as follows:

Ralph J. Adkins (age 54) (present term expires May 20, 1997). Mr. Adkins is President and Chief Executive Officer of Chesapeake. He has served as President and Chief Executive Officer since November 8, 1990. Prior to holding his present position, Mr. Adkins served as President and Chief Operating Officer, Executive Vice President, Senior Vice President, Vice President and Treasurer of Chesapeake. Mr. Adkins is also Chairman and Chief Executive Officer of Chesapeake Service Company, and Chairman and Chief Executive Officer of Sharp Energy, Inc., Tri-County Gas Company, Inc., Chesapeake Service Company and Eastern Shore Natural Gas Company, all wholly owned subsidiaries of Chesapeake. He has been a director of Chesapeake since 1989.



John R. Schimkaitis (age 49) (present term expires May 20, 1997). Mr. Schimkaitis is Executive Vice President, Chief Operating Officer and Assistant Treasurer. He has served as Executive Vice President since February 23, 1996. He previously served as Chief Financial Officer, Senior Vice President, Treasurer and Assistant Secretary. From 1983 to 1986 Mr. Schimkaitis was Vice President of Cooper & Rutter, Inc., a consulting firm providing financial services to the utility and cable industries. He was appointed a director of Chesapeake in February 1996.

Philip S. Barefoot (age 50) (present term expires May 20, 1997). Mr. Barefoot joined Chesapeake as Division Manager of Florida Operations in July 1988. In May 1994 he was elected Senior Vice President of Natural Gas Operations, as well as Vice President of Chesapeake Utilities Corporation. Prior to joining Chesapeake, he was employed with Peoples Natural Gas Company where he held the positions of Division Sales Manager, Division Manager and Vice President of Florence Operations.

Michael P. McMasters (age 38) (present term expires May 20, 1997). Mr. McMasters is Vice President, Chief Financial Officer and Treasurer of Chesapeake Utilities Corporation. He has served as Vice President, Chief Financial Officer and Treasurer since December, 1996. He previously served as Vice President of Eastern Shore, Director of Accounting and Rates and Controller. From 1992 to May 1994, Mr. McMasters was employed as Director of Operations Planning for Equitable Gas Company.

## PART II

### Item 5. Market for the Registrant's Common Stock and Related Security Holder Matters

#### (a) Common Stock Dividends and Price Ranges:

The following table sets forth sale price and dividend information for each calendar quarter during the years December 31, 1996 and 1995:

Quarter Ended	High	Low	Close	Dividends Declared Per Share
1996				
March 31	\$17.000	\$14.500	\$16.750	\$0.2325
June 30	17.875	15.875	16.000	0.2325
September 30	17.750	15.125	17.500	0.2325
December 31	18.000	16.375	16.875	0.2325
1995				
March 31	\$13.625	\$12.125	\$13.250	\$0.2250
June 30	13.375	12.250	13.125	0.2250
September 30	14.375	12.250	14.000	0.2250
December 31	15.500	14.000	14.625	0.2250

The common stock of the Company trades on the New York Stock Exchange under the symbol "CPK".

#### (b) Approximate number of holders of common stock as of December 31, 1996:

<u>Title of Class</u>	<u>Number of Shareholders of Record</u>
Common stock, par value \$.4867	2,213

(c) Dividends:

During the years ended December 31, 1996 and 1995, cash dividends have been declared each quarter, in the amounts set forth in the table above.

Indentures to the long-term debt of the Company and its subsidiaries contain a restriction that the Company cannot, until the retirement of its Series I Bonds, pay any dividends after December 31, 1988 which exceed the sum of \$2,135,188 plus consolidated net income recognized on or after January 1, 1989. As of December 31, 1996, the amounts available for future dividends permitted by the Series I covenant are \$13.0 million.

(d) On March 6, 1997, in conjunction with the acquisition of Tri-County Gas Company, Inc., the Company issued 639,000 shares of Company stock to William P. Schneider and James R. Schneider in reliance on the private placement exemption provided by Section 4(2) of the Securities Act of 1933 and Regulation D, thereunder.

**Item 6. Selected Financial Data**

For the Years Ended December 31,	(Dollars in Thousands Except Stock Data)				
	1996	1995	1994	1993	1992
<b>Operating</b>					
Operating revenues	\$119,330	\$104,020	\$98,572	\$85,873	\$75,935
Operating income	\$9,244	\$9,562	\$7,227	\$6,311	\$5,770
Income before cumulative effect of change in accounting principle and discontinued operations	\$6,910	\$7,237	\$4,460	\$3,914	\$3,475
Cumulative effect of change in accounting principle				\$58	
Income from discontinued operations					\$74
Net income	\$6,910	\$7,237	\$4,460	\$3,972	\$3,549
<b>Balance Sheet</b>					
Gross plant	\$127,961	\$115,283	\$110,023	\$100,330	\$91,039
Net plant	\$90,564	\$81,716	\$75,313	\$69,794	\$64,596
Total assets	\$131,138	\$118,794	\$108,271	\$100,988	\$89,557
Long-term debt, net	\$28,984	\$29,795	\$24,329	\$25,682	\$25,668
Common stockholders' equity	\$47,153	\$42,301	\$37,063	\$34,878	\$33,126
Capital expenditures	\$14,302	\$12,100	\$10,653	\$10,064	\$6,720
<b>Common Stock</b>					
Primary earnings per share:					
Income before cumulative effect of change in accounting principle and discontinued operations	\$1.82	\$1.95	\$1.23	\$1.10	\$1.00
Cumulative effect of change in accounting principle				\$0.02	
Income from discontinued operations					\$0.02
Net income	\$1.82	\$1.95	\$1.23	\$1.12	\$1.02
Average shares outstanding	3,793,467	3,701,981	3,632,413	3,556,037	3,477,244
Fully diluted earnings per share:					
Income before cumulative effect of change in accounting principle and discontinued operations	\$1.76	\$1.89	\$1.20	\$1.08	\$0.99
Cumulative effect of change in accounting principle				\$0.02	
Income from discontinued operations					\$0.02
Net income	\$1.76	\$1.89	\$1.20	\$1.10	\$1.01
Average shares outstanding	4,037,048	3,950,724	3,888,190	3,816,295	3,749,130
Cash dividends per share	\$0.93	\$0.90	\$0.88	\$0.86	\$0.86
Book value per share	\$12.41	\$11.37	\$10.15	\$9.76	\$9.50
Common equity/Total capitalization	61.93%	58.67%	60.37%	57.59%	56.34%
Return on equity	14.66%	17.11%	12.03%	11.39%	10.71%
<b>Number of Employees</b>	338	335	320	326	317
<b>Number of Registered Stockholders</b>	2,213	2,098	1,721	1,743	1,674
<b>Heating Degree Days</b>	4,717	4,593	4,398	4,705	4,645
<b>Heating Degree Days (10-year average)</b>	4,596	4,586	4,564	4,588	4,598

## **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### ***Liquidity and Capital Resources***

The Company's capital requirements reflect the capital intensive nature of its business and are attributable principally to its construction program and the retirement of its outstanding debt. The Company relies on cash generated from operations and short-term borrowings to meet normal working capital requirements and to temporarily finance capital expenditures. During 1996, the Company's net cash provided by operating activities, net cash used by investing activities and net cash provided by financing activities were \$11.3 million, \$14.1 million and \$3.7 million, respectively.

On January 23, 1997, the Board of Directors increased the amount the Company was authorized to borrow from various banks and trust companies from \$14.0 million to a ceiling of \$20.0 million. As of December 31, 1996, the Company had four unsecured bank lines of credit, each in the amount of \$8,000,000. Funds provided from these lines of credit are used for short-term cash needs to meet seasonal working capital requirements and to fund portions of its capital expenditures. The outstanding balances of short-term borrowings at December 31, 1996 and 1995 were \$12.0 million and \$4.8 million, respectively. Based upon anticipated cash requirements in 1997, the Company may refinance the short-term debt and provide 1997 capital requirements through the issuance of long-term debt. The timing of such an issuance is dependent upon the nature of the securities involved as well as current market and economic conditions.

In 1996, the Company used cash provided by operating activities coupled with short-term borrowings to fund the capital expenditures and increases in working capital requirements. The increase in working capital was primarily due to the significant increase in natural gas and propane prices during the fourth quarter of 1996. In 1995, the Company's capital additions were funded by operating activities. In 1994, cash provided by operations increased due to the collection of a large amount of underrecovered purchased gas costs present at the end of 1993.

During 1996, 1995 and 1994, capital expenditures were approximately \$14,302,000, \$12,100,000 and \$10,653,000, respectively. For 1997, the Company has budgeted \$18.9 million for capital expenditures. This amount includes \$8.5 million for natural gas distribution, \$4.5 million for natural gas transmission, \$3.8 million for environmental related expenditures, \$1.8 million for propane distribution, \$150,000 for advanced information services and \$150,000 for general plant. The natural gas and propane distribution expenditures are for expansion and improvement of facilities in existing service territories. Natural gas transmission expenditures are for improvement of the pipeline system and completion of the Delaware City compressor station. The advanced information services expenditures are for computer hardware, software and related equipment. Financing for the 1997 construction program is expected to be provided from short-term borrowings, cash from operations and from an issuance of long-term debt. The construction program is subject to continuous review and modification. Actual construction expenditures may vary from the above estimates due to a number of factors including inflation, changing economic conditions, regulation, load growth and the cost and availability of capital.

The Company expects to incur environmental related expenditures during 1997 and in future years (see Note J to the Consolidated Financial Statements), a portion of which may need to be financed through external sources. Management does not expect such financing to have a material adverse effect on the financial position or capital resources of the Company.

### ***Capital Structure***

As of December 31, 1996, common equity represented 61.9% of permanent capitalization, compared to 58.7% in 1995 and 60.4% in 1994. The Company remains committed to maintaining a sound capital structure and strong credit ratings in order 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, helps to ensure that the Company will be able to attract capital from outside sources at a reasonable cost. The achievement of these objectives will provide benefits to customers and creditors, as well as to the Company's investors.

#### ***Financing Activities***

On October 2, 1995, the Company finalized a private placement of \$10 million of 6.91% Senior Notes due in 2010. The Company used the proceeds to retire \$4,091,000 of the 10.85% Senior Notes of Eastern Shore Natural Gas Company, the Company's natural gas transmission subsidiary ("Eastern Shore"), originally due October 1, 2003. The remaining proceeds of \$5,909,000 were used to repay short-term borrowings under the Company's lines of credit. The Company issued no long-term debt in 1996 and 1994. During 1996, the Company repaid a total of approximately \$869,000 of long-term debt, compared to \$5,018,000 and \$1,291,000 in 1995 and 1994, respectively.

The Company issued 33,926, 38,660 and 30,928 shares of common stock in connection with its Automatic Dividend Reinvestment and Stock Purchase Plan during the years of 1996, 1995 and 1994, respectively.

#### ***Results of Operations***

Net income for 1996 was \$6,910,428, as compared to \$7,236,695 for 1995. Exclusive of matters relating to the settlement and associated accruals described below, earnings in 1996 increased by \$320,969. The 1995 net income reflected the settlement between Eastern Shore and the Federal Energy Regulatory Commission ("FERC") regarding Eastern Shore's purchased gas adjustment ("PGA") computation. This settlement, which was a non-recurring event, contributed \$833,000 to 1995 net income due to the reversal of the excess liability for a potential refund previously recorded, and resulted in a reduction in the required level of accruals from \$750,000 after tax in 1994 to \$186,000 after tax in 1995. Earnings before interest and taxes ("EBIT") for the years 1996, 1995 and 1994 were \$13.2 million, \$13.6 million and \$9.8 million.

#### ***Natural Gas Distribution***

The natural gas distribution segment contributed EBIT of \$7.2 million in 1996 compared to \$4.7 million in both 1995 and 1994. The increase in EBIT in 1996 was due to higher gross margin partially offset by higher operating expenses.

Gross margin in 1996 increased \$4.0 million due to a full year of rate increases, which went into effect in 1995, coupled with a 20% increase in deliveries to residential and commercial customers located in the Company's northern service territory. The rate increase became effective during December, 1995 for Maryland operations and interim rates were in effect during June, 1995 for Delaware operations. The rate increases were designed to increase revenues \$975,000 and \$900,000 annually for the Maryland and Delaware operations, respectively. The increase in deliveries to residential and commercial customers located in the Company's northern service territory was related to temperatures which were colder than the previous year.

Gross margin in 1995 increased \$1.7 million due to the partial year of rate increases for the Maryland and Delaware operations in 1995 and an increase of 88% and 23% in transportation and delivery volumes, respectively, by the Florida distribution operations. These increases in Florida's volumes reflected sales to phosphate producing and citrus processing customers and to three co-generation plants.

Operations expenses for 1996 increased by \$583,000 or 7% after increasing by \$1.2 million or 16% in 1995 over 1994. The 1996 increases related to compensation, benefits, data processing costs, uncollectibles and regulatory expenses. The increases in 1995 related to compensation, data processing conversion costs, consulting, legal and regulatory expenses.

Maintenance expenses were slightly less in 1996 compared to 1995, when expenses were \$66,000 or 7% higher than 1994 expenses due to a greater level of maintenance on meter and regulating stations. Depreciation and amortization expense increased due to plant additions placed in service during the past two years. Other taxes increased by \$460,000 or 23% in 1996, partially due to the inclusion of certain state revenue related taxes in 1996.

#### *Natural Gas Transmission*

The natural gas transmission segment contributed EBIT of \$2.5 million, \$6.1 million and \$3.0 million during 1996, 1995 and 1994, respectively. The large increase in 1995 EBIT includes the effect of the settlement between Eastern Shore and the FERC regarding Eastern Shore's PGA computation (see Note K to the Consolidated Financial Statements). The settlement, which was a non-recurring event, contributed \$1.3 million to EBIT for 1995 due to the reversal of excess liability for the potential refund previously recorded, and resulted in a reduction in the required level of accruals from \$1.2 million in 1994 to \$289,000 in 1995. Exclusive of matters relating to the settlement and associated accruals, EBIT decreased \$2.6 million in 1996, increased \$890,000 in 1995 and increased \$1.1 million in 1994.

The reduction in 1996 EBIT of \$2.6 million was primarily the result of a decrease in gross margin on sales to industrial customers. Contributing to the increases in 1995 and 1994 EBIT were increased gross margins, primarily attributable to increased deliveries of industrial sales volumes, offset slightly by higher operating expenses.

The decline in 1996 gross margin resulted from a 67% decrease in volumes delivered, primarily reflecting decreased deliveries to two industrial interruptible customers, a municipal power plant and a methanol plant. The methanol plant shut down operations on April 1, 1996. The management of the methanol plant has indicated that they would monitor methanol prices and would re-evaluate their position as to reopening or permanently closing on or about April 1, 1997. To our knowledge, no decision has been made regarding reopening or permanently closing the methanol plant. During 1996, 1995 and 1994, deliveries to methanol and power plants contributed to gross margin approximately \$284,000, \$2.4 million and \$1.4 million, respectively. These two customers are interruptible customers and have no ongoing commitment, contractual or otherwise, to purchase natural gas from the Company (see Note A to the Consolidated Financial Statements).

Operations expense increased 4% in 1996, primarily reflecting increased compensation and benefit related expenses. Operations expense increased by \$314,000 or 14% in 1995 compared to 1994. The majority of the increases were in payroll, telemetering and legal fees.

Maintenance expense declined slightly in 1996 after declining by \$47,000 or 8% in 1995. Maintenance expenses in 1994 increased by \$125,000 due to the painting of a pipeline bridge structure and a higher level of natural gas main maintenance. Depreciation expense increased in 1996 due to plant placed in service during the past two years.

On October 15, 1996, Eastern Shore filed with the FERC for a rate increase of approximately \$1,445,000. This increase would be effective for only revenues earned on sales to regulated customers.

In connection with the FERC Order relating to the settlement, Eastern Shore applied in December of 1995 to the FERC for a blanket certificate authorizing open access transportation service on its pipeline system. The implementation of open access transportation service, expected to occur during 1997, will provide all of Eastern Shore's customers with the opportunity to transport gas over its system at FERC regulated rates. Open access is thus likely to result in a shift of Eastern Shore's business from margins earned on sales of gas to large industrial customers to a possibly lower margin earned on transportation services. After the implementation of open access, it is expected that Eastern Shore's earnings, which in the past have been driven to a substantial extent by widely varying levels of unregulated sales, will tend to be more stable and closer to a regulated return.

### ***Propane Distribution***

The propane distribution segment contributed EBIT of \$2.1 million, \$1.9 million and \$2.3 million for 1996, 1995 and 1994, respectively. The 1996 increase in EBIT was primarily the result of an increase in gross margin mostly offset by greater operating expenses. The 1995 decrease in EBIT was a combined impact of a decrease in gross margin coupled with greater operating expenses.

The increase in gross margin of \$1.1 million or 12% for 1996 was primarily the result of a 12% increase in sales volumes due to temperatures being colder than the previous year. The decrease in gross margin of \$281,000 for 1995 was primarily due to a 4% decline in sales volume, partially offset by a higher average margin per gallon. Overall, temperatures in 1995 were 4% colder than temperatures in 1994, yet volumes were lower due to the timing and severity of weather conditions experienced in 1994. In 1995, the segment did not secure a contract with one wholesale customer under which it had supplied large quantities of propane, contributing \$64,000 to gross margin, in 1994.

Operations expense for 1996 increased by \$766,000 or 14% after increasing by \$225,000 or 4% in 1995. The increase in expenses for 1996 and 1995 occurred primarily in compensation, benefits and outside services. Maintenance expenses increased by \$84,000 or 28% in 1996 after reducing by \$42,000 or 12% in 1995. The maintenance expense increases occurred primarily on vehicles.

Starting in 1997, the Company will be integrating the operations of Tri-County Gas Company, Inc. ("Tri-County"), acquired on March 6, 1997, and the Company's current propane distribution operations.

### ***Advanced Information Services***

The advanced information services segment contributed EBIT of \$1.3 million, \$1.2 million and \$174,000 for the years 1996, 1995 and 1994. During 1996, revenue and operating expenses decreased by \$1.4 million and \$1.5 million, respectively. These declines resulted from the segment no longer providing facilities management services during 1996. These 1996 declines were partially offset by increases in consulting and programming revenues along with associated operating expenses, such as compensation, benefits and reimbursed costs.

In 1995 revenues increased due to higher consulting and programming revenues, placement services and non-recurring revenue earned by providing services to a large facilities management customer. These services were provided during a period of system conversion by this customer in connection with the termination of its contract. Operating expenses declined in 1995 due to downsizing efforts at the Company's North Carolina operation to change the focus from a product development and facilities management company to a fixed price contract programming services company.

Included in the results of the advanced information services segment for the years ended December 31, 1996, 1995 and 1994 were intersegment revenues of \$711,000, \$1,722,000 and \$2,277,000, respectively, which were eliminated in consolidation. The intercompany LBIT (Loss Before Interest and Taxes) connected with the development of the Company's natural gas distribution billing system, which was finalized during 1995, totaled \$165,000 and \$468,000 for the years 1995 and 1994, respectively.

### ***Other***

Non-operating income was \$379,000, \$357,000 and \$16,000 for 1996, 1995 and 1994, respectively. The 1995 increase was primarily due to a one-time termination fee paid to the advanced information services segment by its largest facilities management customer in connection with a change in control of that customer. This was somewhat offset by costs to downsize the operation to no longer provide facilities management service in connection with its Page-IT™ software.

### ***Environmental Matters***

The Company continues to work with federal and state environmental agencies to assess the environmental impact and explore corrective action at several former gas manufacturing plant sites (see Note J to the Consolidated Financial Statements). The Company believes that any future costs associated with these sites will be recoverable in rates.

### ***Competition***

Historically, the Company's natural gas operations have successfully competed with other forms of energy such as electricity, oil and propane. The principal considerations have been price and to a lesser extent, accessibility. Since Eastern Shore has only recently elected to be an open access pipeline, with implementation during 1997, the Company has not previously been subject to the competitive pressures from other sellers of natural gas. Upon implementation of open access transportation services on Eastern Shore's system, third party suppliers will compete with the Company to sell gas to the local distribution companies and the end users on Eastern Shore's system. Eastern Shore will shift from providing sales service to providing contract storage and transportation services.

The Company's distribution operations located in Delaware and Maryland will then face the possibility of the unbundling of their services to certain industrial customers, thus increasing the competition for sales services. The Company has already addressed these issues in 1994 and 1993 in its Florida distribution operation, when the Company was required to unbundle its services to large industrial customers. The Company established a natural gas brokering and supply operation to compete for these customers' business.

Both the propane distribution and the advanced information services businesses face significant competition from a number of larger competitors with substantially greater resources available to them than the Company. In addition, in the advanced information services business, changes are occurring rapidly which could adversely impact the markets for the Company's services.

### ***Inflation***

Inflation impacts the prices the Company must pay for labor and other goods and services required for operation, maintenance and capital improvements. In recent years, however, the impact of inflation has lessened, except for its effect on purchased gas costs. Although historically stable, these costs were higher in 1996. These costs are passed on to customers through the purchased gas adjustment clause 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 its regulatory commissions for its regulated operations and constantly monitors the returns of its unregulated business operations.

### ***Cautionary Statement***

Statements made herein and elsewhere in this Form 10-K which are not historical fact are forward looking statements. In connection with the "Safe Harbor" provisions of the Private Securities Litigation Reform Act of 1995, the Company is providing the following cautionary statement to identify important factors that could cause its actual results to differ materially from those anticipated in forward looking statements made herein or otherwise by or on behalf of the Company.

A number of factors and uncertainties make it difficult to predict the effect on future operating results, relative to historical results, of Eastern Shore becoming an open access pipeline. First, while open access is likely to diminish industrial interruptible sales margins, such sales have varied widely from year to year and, in future years, might make a less significant contribution to earnings even in the absence of open access. Second, the level of regulated transportation rates that will be in effect under open access has not yet been determined. Third, the outcome of Eastern Shore's rate increase filing with FERC for an increase in revenue earned on sales to regulated customers has not yet been determined. Fourth, there are a number of uncertainties, including the outcome of open access



proceedings and the effects of competition, which will affect whether the Company will be able to provide economical gas marketing services.

In addition, a number of factors and uncertainties affecting other aspects of the Company's business could have a material impact on earnings. With respect to the acquisition of Tri-County, these include: actual performance for the future periods, the actual costs of the acquisition and the ability of the combined company to execute the integration and realize the expected synergies. With respect to the Company's business in general, these include: the seasonality and temperature sensitivity of our natural gas and propane businesses, the relative price of alternative energy sources and the effects of competition both on our unregulated businesses and on natural gas sales once the Company operates in an open access environment.

**Item 8. Financial Statements and Supplemental Data**

**REPORT OF INDEPENDENT ACCOUNTANTS**

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To the Stockholders of  
Chesapeake Utilities Corporation

We have audited the accompanying consolidated balance sheets of Chesapeake Utilities Corporation and Subsidiaries as of December 31, 1996 and 1995, and the related consolidated statements of income, cash flows, stockholders' equity, and income taxes for each of the three years in the period ended December 31, 1996, and the consolidated financial statement schedule listed in Item 14(a)(1) and (2) of this Form 10-K. These financial statements and the financial statement schedule are the responsibility of the Company's Management. Our responsibility is to express an opinion on these financial statements and the financial statement schedule based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. 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. 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Chesapeake Utilities Corporation and Subsidiaries as of December 31, 1996 and 1995, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 1996 in conformity with generally accepted accounting principles. In addition, the consolidated financial statement schedule referred to above, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information required to be included therein.

We have also previously audited, in accordance with generally accepted standards, the consolidated balance sheets and statements of capitalization as of December 31, 1994, 1993 and 1992, and the related consolidated statements of income, cash flows, common stockholders' equity, and income taxes for each of the two years in the period ended December 31, 1993 (none of which are presented herein) and we expressed unqualified opinions on those consolidated financial statements. In our opinion, the information set forth in the Financial Highlights included in the Selected Financial Data for each of the five years in the period ended December 31, 1996, appearing on page 20 is fairly stated in all material respects in relation to the financial statements from which it has been derived.

COOPERS & LYBRAND L.L.P.

Baltimore, Maryland  
February 13, 1997

## CONSOLIDATED BALANCE SHEETS

### Assets

At December 31,	1996	1995
<b>Property, Plant and Equipment</b>		
Natural gas distribution	\$70,497,872	\$64,785,616
Natural gas transmission	30,655,492	25,651,558
Propane distribution	21,101,579	19,645,973
Advanced information services	1,003,850	841,661
Gas plant acquisition adjustment	795,004	795,004
Other plant	3,907,657	3,563,247
Total property, plant and equipment	127,961,454	115,283,059
Less: Accumulated depreciation and amortization	(37,397,752)	(33,567,446)
Net property, plant and equipment	90,563,702	81,715,613
<b>Investments</b>	2,263,068	1,957,218
<b>Current Assets</b>		
Cash and cash equivalents	1,952,998	977,407
Accounts receivable (less allowance for uncollectibles of \$392,412 and \$309,955 in 1996 and 1995, respectively)	13,328,333	12,701,256
Materials and supplies, at average cost	1,160,522	844,786
Propane inventory, at average cost	2,129,914	1,442,633
Storage gas prepayments	3,731,680	2,663,721
Underrecovered purchased gas costs	2,192,170	
Income taxes receivable	112,902	193,916
Prepaid expenses	801,939	842,460
Deferred income taxes	158,010	1,362,289
Total current assets	25,568,468	21,028,468
<b>Deferred Charges and Other Assets</b>		
Environmental regulatory assets	6,650,088	7,113,572
Environmental expenditures, net	1,778,348	1,505,140
Order 636 transition cost	943,209	1,463,157
Other deferred charges and intangible assets	3,371,027	4,010,812
Total deferred charges and other assets	12,742,672	14,092,681
<b>Total Assets</b>	<b>\$131,137,910</b>	<b>\$118,793,980</b>

See accompanying notes

**Capitalization and Liabilities**

At December 31,	1996	1995
<b>Capitalization</b>		
Stockholders' equity		
Common stock	\$1,849,626	\$1,811,211
Additional paid-in capital	18,848,851	17,592,242
Retained earnings	26,780,831	23,385,097
Less: Unearned compensation related to restricted stock awarded	(364,529)	(415,107)
Unrealized gain (loss) on marketable securities, net	38,598	(72,839)
Total stockholders' equity	47,153,377	42,300,604
Long-term debt, net of current portion	28,984,368	29,794,639
Total capitalization	76,137,745	72,095,243
<b>Current Liabilities</b>		
Current portion of long-term debt	791,271	864,849
Short-term borrowings	12,000,000	4,800,000
Accounts payable	13,176,126	11,162,775
Refunds payable to customers	353,734	966,940
Accrued interest	741,768	742,701
Dividends payable	883,621	837,358
Overrecovered purchased gas costs		53,374
Other accrued expenses	3,447,397	3,123,191
Total current liabilities	31,393,917	22,551,188
<b>Deferred Credits and Other Liabilities</b>		
Deferred income taxes	9,798,676	9,136,808
Deferred investment tax credits	876,432	931,247
Environmental liability	6,650,088	7,113,572
Order 636 transition liability	943,209	1,463,157
Accrued pension costs	1,866,660	2,118,545
Other liabilities	3,471,183	3,384,220
Total deferred credits and other liabilities	23,606,248	24,147,549
<b>Commitments and Contingencies</b>		
<i>(Notes J and K)</i>		
<b>Total Capitalization and Liabilities</b>	<b>\$131,137,910</b>	<b>\$118,793,980</b>

See accompanying notes

# **CONSOLIDATED STATEMENTS OF INCOME**

<b>For the Years Ended December 31,</b>	<b>1996</b>	<b>1995</b>	<b>1994</b>
<b><i>Operating Revenues</i></b>	<b>\$119,330,068</b>	<b>\$104,020,416</b>	<b>\$98,572,297</b>
<b><i>Operating Expenses</i></b>			
Purchased gas costs	72,530,507	58,454,410	59,013,165
Operations	22,954,470	21,387,989	19,681,435
Maintenance	2,014,106	2,079,121	2,181,404
Depreciation and amortization	5,101,823	5,461,752	5,140,679
Other taxes	3,538,402	3,050,351	2,798,905
Income taxes	3,946,986	4,025,274	2,529,635
Total operating expenses	110,086,294	94,458,897	91,345,223
<b><i>Operating Income</i></b>	<b>9,243,774</b>	<b>9,561,519</b>	<b>7,227,074</b>
<b><i>Other Income</i></b>			
Interest income	174,359	141,161	123,271
Other income and (deductions), net	173,231	256,237	(144,038)
Income taxes	(83,739)	(105,280)	(12,733)
Allowance for equity funds used during construction	115,434	65,198	49,154
Total other income	379,285	357,316	15,654
<b><i>Income Before Interest Charges</i></b>	<b>9,623,059</b>	<b>9,918,835</b>	<b>7,242,728</b>
<b><i>Interest Charges</i></b>			
Interest on long-term debt	2,392,458	2,282,247	2,322,942
Amortization of debt expense	120,345	109,399	103,859
Other	264,148	383,976	426,242
Allowance for borrowed funds used during construction	(64,320)	(93,482)	(70,237)
Total interest charges	2,712,631	2,682,140	2,782,806
<b><i>Net Income</i></b>	<b>\$6,910,428</b>	<b>\$7,236,695</b>	<b>\$4,459,922</b>
<b><i>Earnings Per Share of Common Stock :</i></b>			
<b>Primary:</b>			
Earnings per share	\$1.82	\$1.95	\$1.23
Average shares outstanding	3,793,467	3,701,891	3,632,413
<b>Fully diluted:</b>			
Earnings per share	\$1.76	\$1.89	\$1.20
Average shares outstanding	4,037,048	3,950,724	3,888,190

See accompanying notes

# CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31,	1996	1995	1994
<b>Operating Activities</b>			
Net Income	\$6,910,428	\$7,236,695	\$4,459,922
Adjustments to reconcile net income to net operating cash:			
Depreciation and amortization	5,782,759	5,905,090	5,786,013
Allowance for equity funds used during construction	(115,434)	(65,198)	(49,154)
Investment tax credit adjustments	(54,815)	(54,815)	(54,815)
Deferred income taxes, net	1,794,147	252,727	(669,404)
Employee benefits	471,869	178,803	492,082
Employee compensation from lapsing of stock restrictions	334,745	431,694	374,121
Allowance for refund		(1,356,705)	1,238,705
Other, net	438,510	(339,080)	424,832
Changes in assets and liabilities:			
Accounts receivable, net	(627,077)	(4,284,963)	1,303,517
Other current assets	(1,949,441)	1,380,216	(979,125)
Other deferred charges	(502,491)	(946,450)	(271,937)
Accounts payable, net	1,300,252	3,149,573	382,913
Refunds payable to customers	(613,206)	399,123	59,999
(Underrecovered) Overrecovered purchased gas costs	(2,245,544)	162,399	1,723,432
Other current liabilities	369,536	948,846	159,910
Net cash provided by operating activities	11,294,238	12,997,955	14,381,011
<b>Investing Activities</b>			
Property, plant and equipment expenditures, net	(14,045,947)	(11,691,192)	(10,473,565)
Allowance for equity funds used during construction	115,434	65,198	49,154
Purchases of investments	(129,406)	(38,836)	
Net cash used by investing activities	(14,059,919)	(11,664,830)	(10,424,411)
<b>Financing Activities</b>			
Common stock dividends, net of amounts reinvested of \$555,121, \$506,941 and \$427,190 in 1996, 1995 and 1994, respectively	(2,959,573)	(2,791,373)	(2,736,388)
Sale of stock	369,709	254,484	201,704
Net borrowings (repayments) under line of credit agreements	7,200,000	(3,200,000)	(900,000)
Proceeds from issuance of long-term debt		10,000,000	
Repayments of long-term debt	(868,864)	(5,017,580)	(1,285,962)
Net cash used by financing activities	3,741,272	(754,469)	(4,720,646)
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	975,591	578,656	(764,046)
<b>Cash and Cash Equivalents at Beginning of Year</b>	977,407	398,751	1,162,797
<b>Cash and Cash Equivalents at End of Year</b>	\$1,952,998	\$977,407	\$398,751
<b>Supplemental Disclosure of Cash Flow Information</b>			
Cash paid for interest	\$2,660,595	\$2,657,972	\$2,652,323
Cash paid for income tax	\$2,122,120	\$3,288,895	\$3,509,034

See accompanying notes

# **CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

For the Years Ended December 31,	1996	1995	1994
<b><i>Common Stock</i></b>			
Balance -- beginning of year	\$1,811,211	\$1,785,514	\$1,754,547
Dividend Reinvestment Plan	16,514	18,816	15,046
USI restricted stock award agreements	10,639	6,881	15,778
Conversion of debentures	429		143
Company's Retirement Savings Plan	9,927		
Exercised stock options	906		
Balance -- end of year	1,849,626	1,811,211	1,785,514
<b><i>Additional Paid-in Capital</i></b>			
Balance -- beginning of year	17,592,242	16,834,823	15,850,319
Dividend Reinvestment Plan	538,607	488,125	412,144
USI restricted stock award agreements	344,570	176,029	458,335
Sale of treasury stock to Company's Retirement Savings Plan		93,265	109,184
Conversion of debentures	14,557		4,841
Company's Retirement Savings Plan	328,464		
Exercised stock options	30,411		
Balance -- end of year	18,848,851	17,592,242	16,834,823
<b><i>Retained Earnings</i></b>			
Balance -- beginning of year	23,385,097	19,480,374	18,219,083
Net income	6,910,428	7,236,695	4,459,922
Cash dividends (1)	(3,514,694)	(3,331,972)	(3,198,631)
Balance -- end of year	26,780,831	23,385,097	19,480,374
<b><i>Treasury Stock</i></b>			
Balance -- beginning of year		(99,842)	(192,362)
Sale of treasury stock to Company's Retirement Savings Plan		99,842	92,520
Balance -- end of year			(99,842)
<b><i>Unearned Compensation</i></b>			
Balance -- beginning of year	(415,107)	(696,679)	(663,557)
Issuance of award	(284,167)	(121,343)	(474,113)
Amortization of prior years' awards	334,745	402,915	440,991
Balance -- end of year	(364,529)	(415,107)	(696,679)
<b><i>Unrealized Gain (Loss) on Marketable Securities (2)</i></b>	38,598	(72,839)	(241,609)
<b><i>Total Stockholders' Equity</i></b>	<b>\$47,153,377</b>	<b>\$42,300,604</b>	<b>\$37,062,581</b>

(1) Dividends per share of common stock were \$.93, \$.90 and \$.88 for the years 1996, 1995 and 1994, respectively.

(2) Net of income tax expense (benefit) of approximately \$25,000, (\$48,000) and (\$160,000) for the years 1996, 1995 and 1994, respectively.

See accompanying notes

## CONSOLIDATED STATEMENTS OF INCOME TAXES

For the Years Ended December 31,	1996	1995	1994
<b><i>Current Income Tax Expense</i></b>			
Federal	\$1,884,609	\$3,182,346	\$2,375,332
State	356,576	621,238	707,190
Investment tax credit adjustments, net	(54,815)	(54,815)	(54,815)
Total current income tax expense	2,186,370	3,748,769	3,027,707
<b><i>Deferred Income Tax Expense</i></b>			
Property, plant and equipment	581,373	455,151	383,306
Deferred gas costs	873,904	(56,915)	(656,772)
Pensions and other employee benefits	107,131	57,508	(169,731)
Alternative minimum tax			230,575
Unbilled revenue	54,320	(260,922)	188,356
Contributions in aid of construction	(6,979)	(283,033)	(32,345)
Environmental expenditures	108,578	272,068	(22,067)
Allowance for refund	121,671	442,064	(580,361)
Other	4,357	(244,136)	173,700
Total deferred income tax expense (1)	1,844,355	381,785	(485,339)
Total Income Tax Expense	\$4,030,725	\$4,130,554	\$2,542,368
(1) Total deferred income tax expense includes \$392,000, \$108,000 and \$66,000 of deferred state income taxes for the years 1996, 1995 and 1994, respectively.			
<b><i>Reconciliation of Effective Income Tax Rates</i></b>			
Federal income tax expense at 34%	3,719,992	3,864,864	2,380,779
State income taxes, net of Federal benefit	505,481	530,471	322,105
Other	(194,748)	(264,781)	(160,516)
Total income tax expense	\$4,030,725	\$4,130,554	\$2,542,368
Effective income tax rate	36.8%	36.3%	36.3%
<b><i>Deferred Income Taxes</i></b>			
Deferred income tax liabilities:			
Property, plant and equipment	\$10,716,757	\$10,363,259	
Deferred gas costs	853,851		
Other	1,322,272	1,149,563	
Total deferred income tax liabilities	12,892,880	11,512,822	
Deferred income tax assets:			
State operating loss carryforwards	3,320	126,073	
Deferred investment tax credit	426,565	454,590	
Unbilled revenue	863,679	918,001	
Pension and other employee benefits	917,568	1,024,698	
Self insurance	545,836	529,559	
Other	495,246	685,382	
Total deferred income tax assets	3,252,214	3,738,303	
Deferred Income Taxes Per Consolidated Balance Sheet	\$9,640,666	\$7,774,519	

See accompanying notes



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### A. Summary of Accounting Policies

#### *Nature of Business*

Chesapeake Utilities Corporation (the "Company") is a diversified utility company. The Company is engaged in natural gas distribution to approximately 34,700 customers located in southern Delaware, Maryland's Eastern Shore and Central Florida. The Company owns a natural gas transmission subsidiary which operates a pipeline from various points in Pennsylvania to the Company's Delaware and Maryland distribution divisions, as well as other utility and industrial customers in Delaware and the Eastern Shore of Maryland. The Company's propane distribution segment serves approximately 23,100 customers in southern Delaware, the Eastern Shore of Maryland and Virginia. The advanced information services segment provides software services and products to a wide variety of clients.

#### *Principles of Consolidation*

The Consolidated Financial Statements include the accounts of the Company and its wholly owned subsidiaries, Eastern Shore Natural Gas Company ("Eastern Shore"), Sharp Energy, Inc. and Chesapeake Service Company. Sharp Energy, Inc.'s accounts include those of its wholly owned subsidiary, Sharpgas, Inc. Chesapeake Service Company's accounts include United Systems, Inc. ("USI"), Capital Data Systems, Inc. and Skipjack, Inc. All significant 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 the Delaware, Maryland and Florida Public Service Commissions with respect to their rates for service, maintenance of their accounting records and various other matters. Eastern Shore is subject to regulation by the Federal Energy Regulatory Commission ("FERC") and the Delaware Public Service Commission. The Company's financial statements are prepared on the basis of generally accepted accounting principles which give appropriate recognition to the ratemaking and accounting practices and policies of the various commissions. The propane and advanced information services subsidiaries are not subject to regulation with respect to rates or maintenance of accounting records.

#### *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. Investments with an original maturity of three months or less are considered cash equivalents.

#### *Property, Plant and Equipment and Depreciation*

Utility property is stated at original cost while the assets of the propane subsidiary are valued at cost. The costs of repairs and minor replacements are charged to income as incurred and the costs of major renewals and betterments are capitalized. Upon retirement or disposition of utility property, the recorded cost of removal, net of salvage value, is charged to accumulated depreciation. Upon retirement or disposition of non-utility property, the gain or loss, net of salvage value, is charged to income. The provision for depreciation is computed using the straight-line method at rates which will amortize the unrecovered cost of depreciable property over the estimated useful life. Depreciation and amortization expense for financial statement purposes is provided at an annual rate averaging 4.50% for natural gas distribution, 2.70% for natural gas transmission, 4.56% for propane distribution, 5.11% for gas plant acquisition adjustments, 16.10% for advanced information services and 2.22% for other plant.

#### ***Allowance for Funds Used During Construction***

The allowance for funds used during construction ("AFUDC") is an accounting procedure whereby the cost of borrowed funds and other funds used to finance construction projects is capitalized as part of utility plant on the balance sheet, crediting the cost as a non-cash item on the income statement. The cost of borrowed and equity funds is segregated between interest expense and other income, respectively. AFUDC was capitalized on utility plant construction at the rates of 9.51%, 7.31% and 7.15% for 1996, 1995 and 1994, respectively.

#### ***Environmental Regulatory Assets***

Environmental regulatory assets represent amounts related to environmental liabilities for which cash expenditures have not been made. As expenditures are incurred the environmental liability can be reduced along with the environmental regulatory asset. These amounts are recorded to either environmental expenditures or accumulated depreciation as cost of removal. All amounts incurred are amortized in accordance with the ratemaking treatment granted in each jurisdiction.

#### ***Other Deferred Charges and Intangible Assets***

Other deferred charges include discount, premium and issuance costs associated with long-term debt, restricted stock earned for services performed but not yet awarded and rate case expenses. The discount, premium and issuance costs are deferred and amortized over the original lives of their respective debt issues. Gains and losses on the reacquisition of debt are amortized over the remaining lives of the original issuances. Rate case expenses are deferred and amortized over periods approved by the applicable regulatory authorities. Intangible assets are associated with the acquisition of non-utility companies, and are being amortized on a straight-line basis over a period of twelve to 40 years. The gross intangible assets were \$1,920,851 and \$5,020,851 at December 31, 1996 and 1995, respectively. Accumulated amortization related to intangible assets was \$962,227 and \$3,587,090 at December 31, 1996 and 1995, respectively.

#### ***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 and tax bases of assets and liabilities, and are measured using current effective income tax rates. The portion of the Company's deferred tax liabilities applicable to utility operations which has not been reflected in current service rates represents income taxes recoverable through future rates.

Investment tax credits on utility property have been deferred and are allocated to income ratably over the lives of the subject property.

The Company had state tax loss carryforwards of \$46,000 and \$2,004,000 at December 31, 1996 and 1995, respectively. The Company anticipates using all of the loss carryforwards at December 31, 1996, and therefore no valuation allowance at December 31, 1996 and 1995 had been recorded. The loss carryforwards expire in various years beginning in 1997 through 2007.

#### ***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 approximate their fair value (see Note C to the Consolidated Financial Statements for disclosure of fair value of investments). The fair value of the Company's long-term debt is estimated using a discounted cash flow methodology. Based on published corporate borrowing rates for debt instruments with similar terms and average maturities, the estimated fair value of the Company's long-term debt

(including current maturities) at December 31, 1996, is approximately \$30.3 million as compared to the carrying value of \$29.8 million. At December 31, 1995, the estimated fair value was approximately \$32.8 million as compared to a carrying value of \$30.7 million.

### ***Operating Revenues***

Revenues for the natural gas distribution divisions of the Company and a portion of Eastern Shore's revenues are based on rates approved by the various commissions. Customers' base rates may not be changed without formal approval by these commissions. The Company, except for its Florida division, recognizes revenues from meters read on a monthly cycle basis. This practice results in unbilled and unrecorded revenue from the cycle date through month-end. The Florida division recognizes revenues based on services rendered and records an amount for gas delivered but not billed. The propane segment recognizes revenue for certain customers on a metered basis and all other customers on an as-delivered basis.

The natural gas distribution divisions of the Company and Eastern Shore have purchased gas adjustment ("PGA") clauses that provide for the adjustment of rates charged to customers as gas costs fluctuate. These amounts are collected or refunded through adjustments to rates in subsequent periods.

The Company had sales to one customer in 1995, an industrial interruptible customer of the natural gas transmission segment, which exceeded 10% of total revenue. Total sales were approximately \$10,600,000 or 10.2% of total revenue during 1995. During 1996 and 1994, no individual customer accounted for 10% or more of operating revenues.

The Company's natural gas transmission and distribution segments have industrial interruptible customers that are charged rates which can be adjusted up or down to make natural gas competitive with alternative fuels. These customers, based on competitive pricing, can choose natural gas or alternative types of supply. Neither the customer nor the Company is obligated by contract to receive or deliver natural gas.

### ***Earnings Per Share***

Primary earnings per common share are based on the weighted average number of shares of common stock outstanding, adjusted for stock options for each year presented. On a fully diluted basis, both earnings and shares outstanding are adjusted to assume the conversion of convertible debentures.

### ***Certain Risks and Uncertainties***

The financial statements are prepared in conformity with generally accepted accounting principles that require management to make estimates (see Note J to the Consolidated Financial Statements for significant estimates) in measuring assets and liabilities and related revenue and expenses. These estimates involve judgements with respect to, among other things, various future economic factors which 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 Statement of Accounting Standards ("SFAS") No. 71. If the Company were required to terminate application of SFAS No. 71 for all of its regulated operations, all such amounts that are deferred would be recognized in the income statement at that time, resulting in a charge to earnings, net of applicable income taxes.

### ***Impairment of Long-Lived Assets***

During 1996, the Company adopted SFAS No. 121 "Accounting for the Impairment of Long-Lived Assets." This statement requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Additionally, the standard requires rate-

regulated companies to write off regulatory assets to earnings whenever those assets no longer meet the criteria for recognition of a regulatory asset as defined by SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation." When circumstances indicate that the carrying amount of an asset may be impaired, the Company estimates the future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the undiscounted expected future cash flows is less than the carrying amount of the asset, the Company recognizes an impairment loss in accordance with SFAS No. 121. The adoption of SFAS No. 121 did not have a material effect on the Company's financial statements.

#### *Reclassification of Prior Years' Amounts*

Certain prior years' amounts have been reclassified to conform with the 1996 presentation.

### **B. Acquisition**

In January 1997, the Company entered into an agreement and plan of merger to acquire all the outstanding common stock of Tri-County Gas Company, Inc. ("Tri-County") and associated properties. The principal business of Tri-County is the distribution of propane to both retail and wholesale customers on the Delmarva Peninsula.

The transaction, which is expected to be completed in the first calendar quarter, will be effected through the exchange of 639,000 shares of the Company's common stock and accounted for as a pooling of interests. Accordingly, historical financial data in future reports will be restated to include Tri-County data. The following unaudited pro forma data summarizes the combined results of operations of the Company and Tri-County as though the transaction had occurred at the beginning of calendar year 1995.

#### **For the Years Ended December 31, (Unaudited pro forma)**

	1996	1995
Operating revenue	\$ 130,234,503	\$ 111,825,347
Operating income before income taxes	\$ 14,034,590	\$ 14,050,757
Operating income	\$ 9,857,769	\$ 9,916,355
Net income	\$ 7,335,790	\$ 7,455,242
Primary earnings per share	\$ 1.66	\$ 1.72
Fully diluted earnings per share	\$ 1.61	\$ 1.67

The unaudited pro forma data does not purport to be indicative of what results may occur of the combined companies in the future.

### **C. Investments**

The investment balance at December 31, 1996 and 1995 consists primarily of the common stock of Florida Public Utilities Company ("FPU"). The Company's ownership at December 31, 1996 and 1995 represents a 7.41% and 7.04% interest, respectively. The Company has classified its investment in FPU as an "Available for Sale" security, which requires that all unrealized gains and losses be excluded from earnings and be reported net of income tax as a separate component of stockholders' equity. At December 31, 1996, the market value exceeded the aggregate cost basis of the Company's portfolio by \$63,598. The aggregate cost basis of the Company's portfolio at December 31, 1995 exceeded its market value by \$120,839.

#### **D. Lease Obligations**

The Company has entered into several operating leases for office space at various locations. Rent expense related to these leases was \$293,038, \$409,214 and \$418,047 for 1996, 1995 and 1994, respectively. Future minimum payments under the Company's current lease agreements are \$220,103; \$139,533; \$141,958; \$146,454 and \$74,396 for the years of 1997 through 2001, respectfully; and \$114,261 thereafter.

## E. Segment Information

For the Years Ended December 31,	1996	1995	1994
<b>Operating Revenues, Unaffiliated Customers</b>			
Natural gas distribution	\$74,904,076	\$54,120,280	\$49,523,743
Natural gas transmission	15,188,777	24,984,767	22,191,896
Propane distribution	22,333,969	17,607,956	20,684,150
Advanced information services and other	6,903,246	7,307,413	6,172,508
Total operating revenues, unaffiliated customers	<u>\$119,330,068</u>	<u>\$104,020,416</u>	<u>\$98,572,297</u>
<b>Intersegment Revenues *</b>			
Natural gas distribution	\$8,711	\$42,037	\$55,888
Natural gas transmission	21,543,327	16,663,043	17,303,529
Propane distribution	2,059	139,052	85,552
Advanced information services and other	710,949	1,722,135	2,277,361
Total intersegment revenues	<u>\$22,265,046</u>	<u>\$18,566,267</u>	<u>\$19,722,330</u>
<b>Operating Income Before Income Taxes</b>			
Natural gas distribution	\$7,167,236	\$4,728,348	\$4,696,659
Natural gas transmission	2,458,442	6,083,440	3,018,212
Propane distribution	2,053,299	1,852,630	2,287,688
Advanced information services and other	1,305,203	1,170,970	174,033
Total	<u>12,984,180</u>	<u>13,835,388</u>	<u>10,176,592</u>
Add (Less): Eliminations	206,580	(248,595)	(419,883)
Total operating income before income taxes	<u>\$13,190,760</u>	<u>\$13,586,793</u>	<u>\$9,756,709</u>
<b>Depreciation and Amortization</b>			
Natural gas distribution	\$2,854,843	\$2,502,531	\$2,136,979
Natural gas transmission	697,834	638,099	641,485
Propane distribution	1,306,053	1,312,048	1,323,698
Advanced information services	131,877	969,588	1,021,944
Other plant	111,216	39,486	16,573
Total depreciation and amortization	<u>\$5,101,823</u>	<u>\$5,461,752</u>	<u>\$5,140,679</u>
<b>Capital Expenditures</b>			
Natural gas distribution	\$6,634,827	\$7,236,848	\$8,160,874
Natural gas transmission	5,567,509	1,335,793	619,852
Propane distribution	1,693,113	1,640,203	828,519
Advanced information services	162,189	114,461	411,957
Other plant	244,120	1,772,454	632,137
Total capital expenditures	<u>\$14,301,758</u>	<u>\$12,099,759</u>	<u>\$10,653,339</u>
<b>Identifiable Assets, at December 31,</b>			
Natural gas distribution	\$81,250,030	\$75,630,741	\$68,528,774
Natural gas transmission	23,981,989	19,292,524	17,792,415
Propane distribution	20,791,588	18,855,507	16,949,431
Advanced information services	1,496,418	1,635,100	3,196,064
Other	3,617,885	3,380,108	1,803,933
Total identifiable assets	<u>\$131,137,910</u>	<u>\$118,793,980</u>	<u>\$108,270,617</u>

\* All significant intersegment revenues have been eliminated from consolidated revenues.

## F. Long-Term Debt

The outstanding long-term debt, net of current maturities is as follows:

At December 31,	1996	1995
First mortgage sinking fund bonds:		
Adjustable rate Series G*, due January 1, 1998	\$62,500	\$312,500
9.37% Series I, due December 15, 2004	4,820,000	5,340,000
12.00% Mortgage, due February 1, 1998	14,868	28,139
8.25% Convertible debentures, due March 1, 2014	4,087,000	4,114,000
7.97% Senior uncollateralized note, due February 1, 2008	10,000,000	10,000,000
6.91% Senior uncollateralized note, due October 1, 2010	10,000,000	10,000,000
Total long-term debt	\$28,984,368	\$29,794,639

\* The Series G bonds are subject to an interest rate equal to seventy-three percent (73%) of the prime rate (8.25% and 8.5% at December 31, 1996 and 1995), respectively.

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 1996, \$15,000 in debentures were converted. The debentures are redeemable at the option of the holder, subject to an annual non-cumulative maximum limitation of \$200,000 in the aggregate. As of December 31, 1996, approximately \$8,000 of the debentures have been accepted for redemption in 1997. At the Company's option, the debentures may be redeemed at the stated amounts.

On October 2, 1995, the Company issued \$10,000,000 of 6.91% senior notes due on October 1, 2010. The Company used a portion of the proceeds to repay \$4,091,000 of the 10.85% senior notes that were originally due October 1, 2003.

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% of total capitalization, the times interest earned ratio must be at least 2.5 and the Company cannot, until the retirement of its Series I bonds, pay any dividends after December 31, 1988 which exceed the sum of \$2,135,188 plus consolidated net income recognized on or after January 1, 1989. As of December 31, 1996, the amounts available for future dividends permitted by the Series I covenant approximated \$13.0 million.

A portion of the natural gas distribution plant assets owned by the Company are subject to a lien under the mortgage pursuant to which the Company's first mortgage sinking fund bonds are issued.

Annual maturities of consolidated long-term debt for the years 1997 through 2001 are \$791,271, \$597,368, \$1,520,000, \$2,665,091 and \$2,665,091.

## G. Short-Term Borrowings

The Board of Directors has authorized the Company to borrow up to \$20,000,000 from various bank and trust companies. As of December 31, 1996, the Company had four \$8,000,000 unsecured bank lines of credit, none of which required compensating balances. Under these lines of credit at December 31, 1996 and 1995, the Company had short-term debt outstanding of \$12,000,000 and \$4,800,000, respectively, with a weighted average interest rate of 6.12% and 6.00%, respectively.

## H. Common Stock, Additional Paid-in Capital and Treasury Stock

The following is a schedule of changes in the Company's shares of common stock.

For the Years Ended December 31,	1996	1995	1994
<b>Common Stock: Shares issued and outstanding*</b>			
Balance - beginning of year	3,721,589	3,668,791	3,605,152
Dividend Reinvestment Plan	33,926	38,660	30,928
USI restricted stock award agreements	21,859	14,138	32,418
Conversion of debentures	881		293
Exercised stock options	1,863		
Sale of stock to Company's Retirement Savings Plan	20,398		
Balance - end of year	3,800,516	3,721,589	3,668,791
<b>Shares of common stock held in treasury</b>			
Balance - beginning of year		15,609	30,084
Sale of stock to Company's Retirement Savings Plan		(15,609)	(14,475)
Balance - end of year			15,609

\*12,000,000 shares are authorized at a par value of \$.4867 per share.

Certain key USI employees entered into restricted stock award agreements under which shares of Chesapeake common stock can be issued. Shares were awarded as a non-cash transaction over a five-year period beginning in 1992, and restrictions lapse over a five to ten-year period from the award date, if certain financial targets are met. At December 31, 1996 and 1995, respectively, 24,350 and 29,598 shares valued at \$364,529 and \$415,107 remain restricted.

The Performance Incentive Plan, which was adopted in 1992, provides for the granting of stock options to certain officers of the Company over a 10-year period. In November 1994, the Company executed Tandem Stock Option and Performance Share Agreements ("Agreements") with certain executive officers. These Agreements provide the participants an option to purchase shares of the Company's common stock, exercisable in cumulative installments of one-third on each anniversary of the commencement of the award period. The Agreements also enable the participants the right to earn performance shares upon the Company's achievement of the performance goals set forth in the Agreements. When performance shares are issued, the option will expire. Exercise of the option will cancel the participant's right to earn a corresponding number of performance shares. In 1996, the Company recorded \$276,522 to recognize the compensation expense associated with the performance shares. Changes in outstanding options were as follows:

	1996 Number of shares	Option price	1995 Number of shares	Option price	1994 Number of shares	Option price
Balance - beginning of year	125,186	\$12.625 - \$12.75	136,186	\$12.625 - \$12.75	80,280	\$12.75
Options granted					55,906	\$12.625
Options exercised	(12,135)	\$12.75				
Options forfeited			(11,000)	\$12.625		
Balance - end of year	113,051	\$12.625 - \$12.75	125,186	\$12.625 - \$12.75	136,186	\$12.625 - \$12.75
Exercisable	83,114	\$12.625 - \$12.75	80,280	\$12.75	53,520	\$12.75



During 1996, the Company adopted SFAS No. 123, "Accounting for Stock-Based Compensation", for note disclosure purposes only, as prescribed by the standard. No stock options were granted during 1996 or 1995, and therefore, no pro forma disclosures have been provided.

## I. Employee Benefit Plans

### *Pension Plan*

The Company sponsors a defined benefit pension plan covering substantially all of its employees. Benefits under the plan are based on each participant's years of service and highest average compensation. 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.

### *Total Net Pension Cost*

For the Years Ended December 31,	1996	1995	1994
Service cost	\$656,985	\$474,000	\$592,294
Interest cost	658,238	562,003	518,184
Less: Actual (return) loss on assets	(1,142,287)	(1,546,325)	742,949
Net amortization and deferral	269,135	689,947	(1,465,744)
Total net pension cost	442,071	179,625	387,683
Amounts capitalized as construction cost	(38,860)	(30,740)	(52,549)
Amount charged to expense	\$403,211	\$148,885	\$335,134
Discount rate used in calculating net pension cost	7.25%	8.50%	7.00%

The following schedule sets forth the funding status of the pension plan at December 31, 1996 and 1995.

### *Accrued Pension Cost*

At December 31,	1996	1995
Vested	\$6,834,661	\$5,730,239
Non-vested	139,483	100,878
Total accumulated benefit obligation	\$6,974,144	\$5,831,117
Plan assets at fair value	\$10,720,514	\$9,173,094
Projected benefit obligation	(10,265,987)	(9,331,890)
Plan assets less projected benefit obligation	454,527	(158,796)
Unrecognized net gain	(2,820,957)	(2,319,138)
Unamortized net assets from adoption of SFAS No. 87	(141,579)	(156,683)
Accrued pension cost	(\$2,508,009)	(\$2,634,617)

### *Assumptions:*

Discount rate	7.25%	7.25%
Average increase in future compensation levels	4.75%	5.50%
Expected long-term rate of return on assets	8.50%	8.50%

### ***Other Postretirement Benefits***

The Company sponsors a defined benefit postretirement health care and life insurance plan that covers substantially all natural gas and corporate employees. In the first quarter of 1994, the Company increased the amount that future retirees would be required to contribute to participate in the Company's health care program. The change reduced the Company's transition obligation and annual costs to \$357,000 and \$70,000, respectively. The change also resulted in a one-time curtailment loss of \$64,000 in 1994. The Company had deferred approximately \$126,000, which represented the difference between the Maryland division's SFAS No. 106 expense and its actual pay-as-you-go cost. The amount is being amortized over five years starting in 1995. The unamortized balance is \$101,000 at December 31, 1996.

### ***Net Periodic Postretirement Benefit Cost***

At December 31,	1996	1995	1994
Service cost	\$2,820	\$1,827	\$3,553
Interest cost on APBO	54,651	59,706	44,118
Amortization of transition obligation over 20 years	27,859	27,859	22,148
Curtailment loss			63,821
<b><i>Net periodic postretirement benefit cost</i></b>	<b>85,330</b>	<b>89,392</b>	<b>133,640</b>
Amount capitalized as construction cost	(16,672)	(14,010)	(20,134)
Amount deferred		(20,561)	(13,212)
<b>Amount charged to expense</b>	<b>\$68,658</b>	<b>\$54,821</b>	<b>\$100,294</b>
<b><i>Assumption:</i></b>			
Discount rate	7.25%	8.50%	7.00%

### ***Accrued Postretirement Benefit Liability***

At December 31,	1996	1995
<b><i>Accumulated postretirement benefit obligation:</i></b>		
Retirees	\$567,599	\$616,664
Fully eligible active employees	137,378	135,297
Other active	86,894	90,724
<b>Total accumulated postretirement benefit obligation</b>	<b>791,871</b>	<b>842,685</b>
Unrecognized transition obligation	(273,013)	(300,872)
Unrecognized net (loss) gain	(67,155)	(70,873)
<b><i>Accrued postretirement liability</i></b>	<b>\$451,703</b>	<b>\$470,940</b>
<b><i>Assumption:</i></b>		
Discount rate	7.25%	7.25%

The health care inflation rate for 1996 is assumed to be 10%. This rate is projected to gradually decrease to an ultimate rate of 5% by the year 2007. A one percentage point increase in the health care inflation rate from the assumed rate would increase the accumulated postretirement benefit obligation by approximately \$90,396 as of January 1, 1997, and would increase the aggregate of the service cost and interest cost components of net periodic postretirement benefit cost for 1997 by approximately \$7,366.

### ***Retirement Savings Plan***

The Company sponsors a Retirement Savings Plan, a 401(k) plan ("Plan"), which provides participants a mechanism for making contributions for retirement savings. Each participant may make pre-tax contributions based upon eligible compensation. The Company makes a contribution equal to 60% or 100% of each participant's pre-tax contributions, not to exceed 6%, of the participant's eligible compensation for the plan year. The Company's contributions totaled \$353,350, \$301,794 and \$240,103 for the years ended December 31, 1996, 1995 and 1994, respectively. As of December 31, 1996, there are 79,602 shares reserved to fund future contributions to the Plan.

## **J. Environmental Commitments and Contingencies**

The Company currently is participating in the investigation, assessment or remediation of four former gas manufacturing plant sites located in different jurisdictions, including the exploration of corrective action options to remove environmental contaminants. The Company has accrued liabilities for two of these sites, the Dover Gas Light and Salisbury Town Gas Light sites.

The Dover site has been listed by the Environmental Protection Agency Region III ("EPA") on the Superfund National Priorities List under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"). On August 19, 1994, the EPA issued the Record of Decision ("ROD") for the site, which selected a remedial plan and estimated the costs of the selected remedy at \$2.7 million for ground-water remediation and \$3.3 million for soil remediation. On May 17, 1995, EPA issued an order to the Company under Section 106 of CERCLA (the "Order"), which requires the Company to fund or implement the ROD. The Order was also issued to General Public Utilities Corporation, Inc. ("GPU"), which both EPA and the Company believe is liable under CERCLA. Other potentially responsible parties ("PRPs") such as the State of Delaware were not ordered to perform the ROD. In July 1996, the Company commenced the design phase of the ROD, on-site pre-design and investigation. A pre-design investigation report ("the report") was filed in October 1996 with the EPA. The report, which requires EPA approval, will provide up to date status on the site, which the EPA will use to determine if the remedial design selected in the ROD is still the appropriate remedy.

On March 6, 1995, the Company commenced litigation against the State of Delaware for contribution to the remedial costs being incurred to carry out the ROD. In December of 1995, this case was dismissed without prejudice based on a settlement agreement between the parties (the "Settlement"). Under the Settlement, the State agreed to contribute \$600,000 toward the cost of implementing the ROD and to reimburse the EPA for \$400,000 in oversight costs. The Settlement is contingent upon a formal settlement agreement between EPA and the State of Delaware being reached within the next two years. Upon satisfaction of all conditions of the Settlement, the litigation will be dismissed with prejudice.

On June 25, 1996, the Company initiated litigation against one of the other PRPs for contribution to the remedial costs incurred by Chesapeake in connection with complying with the ROD. At this time, management cannot predict the outcome of the litigation or the amount of proceeds to be received, if any.

The Company is currently engaged in investigations related to additional parties who may be PRPs. Based upon these investigations, the Company will consider suit against other PRPs. The Company expects continued negotiations with PRPs in an attempt to resolve these matters.

In the third quarter of 1994, the Company increased its liability recorded with respect to the Dover site to \$6.0 million. This amount reflected the EPA's estimate, as stated in the ROD, for remediation of the site according to the ROD. The recorded liability may be adjusted upward or downward as the design phase progresses and the Company obtains construction bids for performance of the work. The Company has also recorded a regulatory asset

of \$6.0 million, corresponding to the recorded liability. Management believes that in addition to the \$600,000 expected to be contributed by the State of Delaware under the Settlement, the Company will be equitably entitled to contribution from other responsible parties for a portion of the expenses to be incurred in connection with the remedies selected in the ROD. Management also believes that the amounts not so contributed will be recoverable in the Company's rates.

During 1996, the Company completed construction and began remediation procedures at the Salisbury site and will be reporting, on an ongoing basis, the remediation and monitoring results to the Maryland Department of the Environment. The Company has accrued a liability with respect to the Salisbury site of \$650,088 as of December 31, 1996. This amount is based on the estimated operating costs of the remediation facilities. A corresponding regulatory asset has been recorded, reflecting the Company's belief that costs incurred will be recoverable in rates.

Portions of the liability payouts for the Dover and Salisbury sites are expected to be over 30 and five-year periods, respectively. In addition, the Company has two other sites. One site located in the state of Florida, is currently being evaluated for which no estimate of liability can be made at this time. The other site has been remediated, and in 1996 the Company received the site closure certificate. It is management's opinion that any unrecovered current costs and any other future costs incurred will be recoverable through future rates or sharing arrangements with other responsible parties.

At December 31,	1996	1995
Environmental Costs Incurred		
Delaware	\$4,423,843	\$3,929,417
Maryland	2,187,810	1,805,572
Florida	660,828	629,153
	<u>7,272,481</u>	<u>6,364,142</u>
Less: Amounts approved for ratemaking treatment, net of insurance proceeds	6,396,108	6,066,096
Amounts pending ratemaking recovery	<u>\$876,373</u>	<u>\$298,046</u>

## K. Commitments and Contingencies

### *FERC PGA*

On May 19, 1994, the FERC issued an Order directing Eastern Shore Natural Gas Company ("Eastern Shore") to refund, with interest, what the FERC characterized as overcharges from November 1, 1992 to the current billing month. Eastern Shore contested the order and requested a rehearing. Subsequently, Eastern Shore and the FERC entered into negotiations to resolve this issue.

In response to the FERC's May 19, 1994 Order, Eastern Shore accrued \$412,000 during the second quarter of 1994 as an estimated liability for potential refunds relating to prior periods. Thereafter, Eastern Shore accrued each month to ensure that the potential refund was fully accrued. On August 17, 1995, the FERC issued an Order approving an Offer of Settlement submitted by Eastern Shore. The Order approved a change in Eastern Shore's PGA methodology retroactive to June 1, 1994, which resulted in a rate reduction of approximately \$234,000 per year. The reserves that the Company had accrued for the potential refund were significantly greater than the rate reduction ordered. Accordingly, Eastern Shore reversed a large portion of the estimated liability that had been accrued. This reversal contributed \$1,385,000 to pre-tax earnings, or \$833,000 to after-tax earnings, during the third quarter of 1995. In connection with the offer of settlement and the resulting FERC Order, Eastern Shore applied in December 1995 to the FERC for a blanket certificate authorizing open access transportation service on its

pipeline system. The implementation of open access transportation service, expected to occur during 1997, will provide all of Eastern Shore's customers with the opportunity to transport gas over its system at FERC regulated rates. Open access is thus likely to result in a shift of Eastern Shore's business from margins earned on sales of gas to large industrial customers, to a possibly lower margin earned on transportation services.

#### ***Other Commitments and Contingencies***

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 of the Company.

### **L. 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. Due to the seasonal nature of the Company's business, there are substantial variations in operations reported on a quarterly basis.

1996	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Operating Revenue	\$44,270,265	\$23,850,551	\$18,475,914	\$32,733,338
Operating Income	\$5,277,681	\$1,401,082	\$153,444	\$2,411,567
Net Income	\$4,649,009	\$832,457	(\$390,871)	\$1,819,833
Primary Earnings Per Share	\$1.24	\$0.22	(\$0.10)	\$0.48
Fully Diluted Earnings Per Share	\$1.17	\$0.22	(\$0.10)	\$0.46
1995				
Operating Revenue	\$30,896,798	\$22,074,663	\$20,564,994	\$30,483,961
Operating Income	\$4,330,962	\$1,369,342	\$1,492,200	\$2,369,015
Net Income	\$3,658,431	\$764,085	\$988,122	\$1,826,057
Primary Earnings Per Share	\$1.00	\$0.21	\$0.27	\$0.49
Fully Diluted Earnings Per Share	\$0.95	\$0.21	\$0.26	\$0.47

Results for the third quarter 1995 reflect a non-recurring increase in net income of \$833,000, (see Note K to the Consolidated Financial Statements).

## OPERATING STATISTICS

For the Years Ended December 31,	1996	1995	1994	1993	1992
<b>Revenues (In thousands)</b>					
Natural gas					
Residential	\$18,256	\$14,857	\$15,228	\$14,007	\$12,935
Commercial	14,339	11,383	11,594	10,837	9,857
Industrial	28,546	36,898	32,718	31,622	26,977
Sale for resale	24,481	12,459	9,586	5,242	3,843
Transportation	3,369	2,993	2,639	2,480	2,400
Other	1,102	515	(50)	193	(134)
Total natural gas revenues	90,093	79,105	71,715	64,381	55,878
Propane	22,334	17,608	17,789 *	16,908	16,489
Other	6,903	7,307	6,173	4,584	3,568
Total revenues	\$119,330	\$104,020	\$95,677	\$85,873	\$75,935
<b>Volumes</b>					
Natural gas deliveries (in MMCF)					
Residential	1,987	1,686	1,665	1,596	1,561
Commercial	2,092	1,792	1,771	1,676	1,633
Industrial	7,501	13,622	10,752	9,308	8,014
Sale for resale	1,065	990	998	984	997
Transportation	12,096	11,131	7,542	5,880	5,139
Total natural gas deliveries	24,741	29,221	22,728	19,444	17,344
Propane (in thousands of gallons)	19,853	17,748	18,395 *	17,250	17,125
<b>Customers</b>					
Natural gas					
Residential	30,349	29,285	28,260	27,312	26,523
Commercial	4,151	4,030	3,879	3,759	3,683
Industrial **	210	212	204	196	198
Sale for resale **	3	3	3	3	3
Total natural gas customers	34,713	33,530	32,346	31,270	30,407
Propane	23,096	22,609	22,180	21,622	21,132
Total customers	57,809	56,139	54,526	52,892	51,539

\* Excludes revenue of \$2,895,000, which resulted from the sale of nine million gallons of propane to one large wholesale customer in 1994.

\*\* Includes transportation customers.

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

None

**PART III**

**Item 10. Directors and Executive Officers of the Registrant**

Information pertaining to the Directors of the Company is incorporated herein by reference to the Proxy Statement, under "Information Regarding the Board of Directors and Nominees", dated and to be filed on or before April 4, 1997 in connection with the Company's Annual Meeting to be held on May 20, 1997.

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 Item 10 of Part I of this Form 10-K under "Executive Officers of the Registrant."

**Item 11. Executive Compensation**

This information is incorporated herein by reference to the Proxy Statement, under "Report on Executive Compensation", dated and to be filed on or before April 4, 1997 in connection with the Company's Annual Meeting to be held on May 20, 1997.

**Item 12. Security Ownership of Certain Beneficial Owners and Management**

This information is incorporated herein by reference to the Proxy Statement, under "Beneficial Ownership of the Company's Securities", dated and to be filed on or before April 4, 1997 in connection with the Company's Annual Meeting to be held on May 20, 1996.

**Item 13. Certain Relationships and Related Transactions**

This information is incorporated herein by reference to the Proxy Statement, under "Beneficial Ownership of the Company's Securities", dated and to be filed on or before April 4, 1997 in connection with the Company's Annual Meeting to be held on May 20, 1997.

**PART IV**

**Item 14. Financial Statements, Financial Statement Schedules, and Exhibits and Reports on Form 8-K**

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

**1. Financial Statements:**

- Accountants' Report dated February 13, 1997 of Coopers & Lybrand L.L.P., Independent Accountants
- Consolidated Statements of Income for each of the three years ended December 31, 1996, 1995 and 1994
- Consolidated Balance Sheets at December 31, 1996 and December 31, 1995
- Consolidated Statements of Cash Flows for each of the three years ended December 31, 1996, 1995 and 1994

- Consolidated Statements of Common Stockholders' Equity for each of the three years ended December 31, 1996
- Consolidated Statements of Income Taxes for each of the three years ended December 31, 1996
- Notes to Consolidated Financial Statements

2. The following additional information for the years 1996, 1995 and 1994 is submitted herewith:  
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.

**(b) Reports on Form 8-K**

On January 13, 1997, the Company filed a report on Form 8-K, reporting under Item 5 that the Company has agreed to purchase all of the outstanding shares of Tri-County Gas Company, Inc.

**(c) Exhibits**

**Exhibit 3.(a) - Certificate of Incorporation**

Amended Certificate of Incorporation of Chesapeake Utilities Corporation, is incorporated herein by reference to Exhibit 3.(b) to the Form 10-Q for the quarterly period ended June 30, 1995, of Chesapeake Utilities Corporation.

**Exhibit 3.(b) - Bylaws**

Amended Bylaws of Chesapeake Utilities Corporation, are incorporated herein by reference to Exhibit 3.(b) to the Annual Report on Form 10-K for the year ended December 31, 1994 of Chesapeake Utilities Corporation.

**Exhibit 4.(a) - The 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.**

**Exhibit 4.(b) - 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 \$10,000,000 7.97% Unsecured Senior Notes due February 1, 2008, is incorporated herein by reference to Exhibit 4.(b) to the Annual Report on Form 10-K for the year ended December 31, 1992, of Chesapeake Utilities Corporation.\***

**Exhibit 4.(c) - The Directors Stock Compensation Plan adopted by Chesapeake Utilities Corporation in 1995, is incorporated herein by reference to the Company's Proxy Statement dated April 17, 1995, in connection with the Company's annual meeting held in May, 1995.**

**Exhibit 4.(d) The 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 Commission upon request.

- Exhibit 10.(a) - Service Agreement dated November 1, 1989, by and between Transcontinental Gas Pipe Line Corporation and Eastern Shore Natural Gas Company, is incorporated herein by reference to Exhibit 10.(a) to the Annual Report on Form 10-K for the year ended December 31, 1989, of Chesapeake Utilities Corporation.\*
- Exhibit 10.(b) - Service Agreement dated November 1, 1989, by and between Columbia Gas Transmission Corporation and Eastern Shore Natural Gas Company, is incorporated herein by reference to Exhibit 10.(b) to the Annual Report on Form 10-K for the year ended December 31, 1989, of Chesapeake Utilities Corporation.\*
- Exhibit 10.(c) - Service Agreement for General Service dated November 1, 1989, by and between Florida Gas Transmission Company and Chesapeake Utilities Corporation, is incorporated herein by reference to Exhibit 10.(c) to the Annual Report on Form 10-K for the year ended December 31, 1990, of Chesapeake Utilities Corporation.\*
- Exhibit 10.(d) - Service Agreement for Preferred Service dated November 1, 1989, by and between Florida Gas Transmission Company and Chesapeake Utilities Corporation, is incorporated herein by reference to Exhibit 10.(d) to the Annual Report on Form 10-K for the year ended December 31, 1990, of Chesapeake Utilities Corporation.\*
- Exhibit 10.(e) - Service Agreement for Firm Transportation Service dated November 1, 1989, by and between Florida Gas Transmission Company and Chesapeake Utilities Corporation, is incorporated herein by reference to Exhibit 10.(e) to the Annual Report on Form 10-K for the year ended December 31, 1990, of Chesapeake Utilities Corporation.\*
- Exhibit 10.(f) - Form of Service Agreement for Interruptible Sales Services dated May 11, 1990, by and between Florida Gas Transmission Company and Chesapeake Utilities Corporation, is incorporated herein by reference to Exhibit 10.(f) to the Annual Report on Form 10-K for the year ended December 31, 1990, of Chesapeake Utilities Corporation.\*
- Exhibit 10.(g) - Interruptible Transportation Service Agreement dated February 23, 1990, by and between Florida Gas Transmission Company and Chesapeake Utilities Corporation, is incorporated herein by reference to Exhibit 10.(g) to the Annual Report on Form 10-K for the year ended December 31, 1990, of Chesapeake Utilities Corporation.\*
- Exhibit 10.(h) - Interruptible Transportation Service Agreement dated November 30, 1990, by and between Florida Gas Transmission Company and Chesapeake Utilities Corporation, is incorporated herein by reference to Exhibit 10.(h) to the Annual Report on Form 10-K for the year ended December 31, 1990, of Chesapeake Utilities Corporation.\*
- Exhibit 10.(i) - Executive Employment Agreement dated March 26, 1992, by and between Chesapeake Utilities Corporation and Ralph J. Adkins is incorporated herein by reference to Exhibit 10.(a) to the Quarterly Report on Form 10-Q for the quarter ended June 30, 1992, of Chesapeake Utilities Corporation.\*

- Exhibit 10.(j) - Executive Employment Agreement dated March 26, 1992, by and between Chesapeake Utilities Corporation and John R. Schimkaitis, is incorporated herein by reference to Exhibit 10.(b) to the Quarterly Report on Form 10-Q for the quarter ended June 30, 1992, of Chesapeake Utilities Corporation.\*
- Exhibit 10.(k) - Chesapeake Utilities Corporation Cash Bonus Incentive Plan dated January 1, 1992, is incorporated herein by reference to Exhibit 10.(o) to the Annual Report on Form 10-K for the year ended December 31, 1991, of Chesapeake Utilities Corporation.\*
- Exhibit 10.(l) - Chesapeake Utilities Corporation Performance Incentive Plan dated January 1, 1992, is incorporated herein by reference to the Company's Proxy Statement dated April 20, 1992, in connection with the Company's Annual Meeting held on May 19, 1992.
- Exhibit 10.(m) - Form of Tandem Stock Option and Performance Share Agreement dated November 18, 1994, pursuant to Chesapeake Utilities Corporation Performance Incentive Plan by and between Chesapeake Utilities Corporation and Ralph J. Adkins, John R. Schimkaitis, Philip S. Barefoot and Jerry D. West, filed is incorporated herein by reference to exhibit 3.(b) to the Annual Report on Form 10-K for the year ended December 31, 1994 for Chesapeake Utilities Corporation.\*
- Exhibit 10.(n) - Agreement and Plan of Merger by and between Chesapeake Utilities Corporation and Tri-County Gas Company, Inc. is incorporated herein by reference from the Form 8-K filed on January 13, 1997.
- Exhibit 11. - Computation of Primary and Fully Diluted Earnings Per Share, filed herewith.
- Exhibit 12. - Computation of Ratio of Earning to Fixed Charges, filed herewith.
- Exhibit 21. - Subsidiaries of the Registrant, filed herewith.
- Exhibit 23. - Consent of Independent Accountants, filed herewith.

\* Filed under commission file #0-593.

## 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/ RALPH J. ADKINS  
Ralph J. Adkins  
President and Chief Executive Officer

Date: March 17, 1997

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/ JOHN W. JARDINE, JR.  
John W. Jardine, Jr.,  
Chairman of the Board and Director

Date: March 17, 1997

/S/ RALPH J. ADKINS  
Ralph J. Adkins, President,  
Chief Executive Officer and Director

Date: March 17, 1997

/S/ JOHN R. SCHIMKAITIS  
John R. Schimkaitis, Executive Vice  
President, Chief Operating Officer,  
Director

Date: March 17, 1997

/S/ MICHAEL P. MCMASTERS  
Michael P. McMasters  
Vice President, Chief Financial  
Officer and Treasurer  
(Principal Financial Officer)

Date: March 17, 1997

/S/ JEREMIAH P. SHEA  
Jeremiah P. Shea, Director

Date: March 17, 1997

/S/ ROBERT F. RIDER  
Robert F. Rider, Director

Date: March 17, 1997

/S/ WILLIAM G. WARDEN, III  
William G. Warden, III, Director

Date: March 17, 1997

/S/ RUDOLPH M. PEINS, JR.  
Rudolph M. Peins, Jr., Director

Date: March 17, 1997

/S/ RICHARD BERNSTEIN  
Richard Bernstein, Director

Date: March 17, 1997

/S/ WALTER J. COLEMAN  
Walter J. Coleman, Director

Date: March 17, 1997

**CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES**  
**SCHEDULE II**  
**VALUATION AND QUALIFYING ACCOUNTS**

**FOR THE YEARS ENDED DECEMBER 31, 1996, 1995 AND 1994**

<u>COLUMN A</u>	<u>COLUMN B</u>	<u>COLUMN C</u>		<u>COLUMN D</u>	<u>COLUMN E</u>
<u>Description</u>	<u>Balance at Beginning of Period</u>	<u>— Additions —</u>		<u>Deductions</u>	<u>Balance at End of Period</u>
		<u>Charged to Costs and Expense</u>	<u>Charged to Other Accounts</u>		
Valuation accounts deducted from assets to which they apply for doubtful accounts receivable:					
1996 .....	\$309,955	\$364,622	\$55,631 (B)	(\$337,796) (A)	\$392,412
1995 .....	\$202,152	\$328,012	\$43,151 (B)	(\$263,360) (A)	\$309,955
1994 .....	\$186,018	\$130,263	\$57,633 (B)	(\$171,762) (A)	\$202,152

**Notes:**

(A) Uncollectible accounts charged off.

(B) Recoveries.

**CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES**  
**EXHIBIT 11**  
**COMPUTATION OF PRIMARY AND FULLY DILUTED EARNINGS PER SHARE**

Item	For the Years Ended December 31,		
	1996	1995	1994
Shares issued at beginning of year	3,721,589	3,668,791	3,605,152
Treasury stock at beginning of year	0	(15,609)	(30,084)
Sale of treasury stock	0	15,609	14,475
Issuance of common stock for dividend reinvestment plan	33,926	38,660	30,928
Issuance of common stock pursuant to USI restricted stock award agreements	21,859	14,138	32,418
Issuance of common stock for conversion of debentures	881	0	293
Exercised stock options	1,863	0	0
Sale of stock to Company's Retirement Savings Plan	20,398	0	0
Shares outstanding at end of year	<u>3,800,516</u>	<u>3,721,589</u>	<u>3,653,182</u>
Primary earnings per share calculation:			
Weighted average number of shares	<u>3,793,467</u>	<u>3,701,891</u>	<u>3,632,413</u>
Consolidated net income	<u>\$6,910,428</u>	<u>\$7,236,695</u>	<u>\$4,459,922</u>
Primary earnings per share	<u>\$1.82</u>	<u>\$1.95</u>	<u>\$1.23</u>
Fully diluted earnings per share calculation:			
Weighted average number of shares	<u>3,794,306</u>	<u>3,701,891</u>	<u>3,632,413</u>
Contingent shares related to assumed conversion of convertible debt	<u>242,742</u>	<u>248,833</u>	<u>255,777</u>
Weighted average number of shares assuming full dilution	<u>4,037,048</u>	<u>3,950,724</u>	<u>3,888,190</u>
Adjusted income			
Net income	<u>\$6,910,428</u>	<u>\$7,236,695</u>	<u>\$4,459,922</u>
Interest on convertible debt	<u>340,697</u>	<u>349,251</u>	<u>358,998</u>
Less: Applicable income taxes	<u>(132,872)</u>	<u>(136,208)</u>	<u>(140,009)</u>
Adjusted net income	<u>\$7,118,253</u>	<u>\$7,449,738</u>	<u>\$4,678,911</u>
Fully-diluted earnings per share	<u>\$1.76</u>	<u>\$1.89</u>	<u>\$1.20 *</u>

**Notes:**

\* This calculation is submitted in accordance with Regulation S-K item 601(b)(11) although not required by footnote 2 to paragraph 14 of APB Opinion No. 15 because it results in dilution of less than 3%.

**CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES**  
**EXHIBIT 12**  
**COMPUTATION OF RATIO OF EARNINGS TO FIXED CHARGES**

	For the Years Ended December 31,		
	1996	1995	1994
Income from continuing operations	\$6,910,428	\$7,236,695	\$4,459,922
Add:			
Income taxes	4,030,725	4,131,177	2,542,368
Portion of rents representative of interest factor	170,530	182,211	187,012
Interest on indebtedness	2,656,606	2,666,223	2,637,654
Amortization of debt discount and expense	120,345	109,399	103,859
Earnings as adjusted	<u>\$13,888,634</u>	<u>\$14,325,705</u>	<u>\$9,930,815</u>
Fixed Charges			
Portion of rents representative of interest factor	\$170,530	\$182,211	\$187,012
Interest on indebtedness	2,656,606	2,666,223	2,637,654
Amortization of debt discount and expense	120,345	109,399	103,859
Fixed Charges	<u>\$2,947,481</u>	<u>\$2,957,833</u>	<u>\$2,928,525</u>
Ratio of Earnings to Fixed Charges	<u>4.71</u>	<u>4.84</u>	<u>3.39</u>

**CHESAPEAKE UTILITIES CORPORATION**  
**EXHIBIT 21**  
**SUBSIDIARIES OF THE REGISTRANT**

**Subsidiaries**

Eastern Shore Natural Gas Company  
Sharp Energy, Inc.  
Chesapeake Services Company  
United Systems, Inc.  
Tri-County Gas Company, Inc.  
Eastern Shore Real Estate

**State Incorporated**

Delaware  
Delaware  
Delaware  
Georgia  
Maryland  
Maryland

**Subsidiary of Eastern Shore Natural Gas Company**

Dover Exploration Company

**State Incorporated**

Delaware

**Subsidiaries of Sharp Energy, Inc.**

Sharpgas, Inc.  
Sharpoil, Inc.

**State Incorporated**

Delaware  
Delaware

**Subsidiaries of Chesapeake Service Company**

Skipjack, Inc.  
Capital Data Systems, Inc.  
Currin and Associates, Inc.  
Chesapeake Investment Company

**State Incorporated**

Delaware  
North Carolina  
North Carolina  
Delaware

## CONSENT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

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We consent to the incorporation by reference in the Prospectuses prepared in accordance with the requirements of Form S-2 (File No. 33-26582), Form S-3 (File Nos. 33-28391, and 33-64671) and Form S-8 (File No. 33-301175) of our report dated February 13, 1997 accompanying the consolidated financial statements and the consolidated financial statement schedule of Chesapeake Utilities Corporation as of December 31, 1996 and 1995 and for each of the three years in the period ended December 31, 1996 included in this Annual Report and Form 10-K of Chesapeake Utilities Corporation.

COOPERS & LYBRAND L.L.P.

Baltimore, Maryland  
March 17, 1997



*Chesapeake will provide, without charge,  
upon written request, a copy of any exhibit to  
Chesapeake's Annual Report on Form 10-K  
not included herewith.*

## SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

## FORM 10-Q

- ☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 1997

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 001-11590

## CHESAPEAKE UTILITIES CORPORATION

(Exact name of registrant as specified in its charter)

Delaware  
(State of other jurisdiction of  
incorporation or organization)

51-0064146  
(I.R.S. Employer  
Identification No.)

909 Silver Lake Boulevard, Dover, Delaware 19904  
(Address of principal executive offices) (Zip Code)

(302) 734-6798  
(Registrant's Telephone Number, Including Area Code)

\_\_\_\_\_  
(Former name, former address and former fiscal year, if changed since last report.)

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 ☒ No ☐.

Common Stock, par value \$.4867 - 4,481,394 shares issued as of September 30, 1997.

**CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

	September 30, 1997 (Unaudited)	December 31, 1996 (As restated)
<b>Capitalization and Liabilities</b>		
<b>Capitalization</b>		
Stockholders' equity		
Common Stock, par value \$.4867 per share; (authorized 12,000,000 shares; issued 4,481,394 and 4,439,516 shares, respectively)	\$2,181,014	\$2,160,628
Additional paid-in capital	19,433,280	18,745,718
Retained earnings	26,947,737	26,957,049
Less:		
Unearned compensation - restricted stock awards	(234,348)	(364,529)
Net unrealized gain on marketable securities	64,560	38,598
Total stockholders' equity	48,392,243	47,537,464
Long-term debt, net of current portion	28,642,000	30,776,919
Total capitalization	77,034,243	78,314,383
<b>Current Liabilities</b>		
Current portion of long-term debt	659,868	1,285,938
Short-term borrowings	18,400,000	12,700,000
Accounts payable	6,348,741	14,426,983
Refunds payable to customers	336,575	353,734
Income taxes payable	216,574	
Accrued interest	619,444	741,768
Dividends payable	1,086,650	883,621
Other accrued expenses	3,862,271	3,733,235
Total current liabilities	31,530,123	34,125,279
<b>Deferred Credits and Other Liabilities</b>		
Deferred income taxes	10,230,179	9,798,676
Deferred investment tax credits	840,201	876,432
Environmental liability	6,501,505	6,650,088
Accrued pension costs	2,230,258	1,866,660
Order 636 transition liability	0	943,209
Other liabilities	3,453,703	3,471,183
Total deferred credits and other liabilities	23,255,846	23,606,248
<b>Total Capitalization and Liabilities</b>	<b>\$131,820,212</b>	<b>\$136,045,910</b>

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

**CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED INCOME STATEMENTS**

	For the Nine Months Ended September 30,	
	1997 (Unaudited)	1996 (As restated)
Operating Revenues	\$88,286,384	\$93,896,237
Operating Expenses		
Purchased gas costs	52,983,499	56,200,448
Operations	19,138,841	18,409,062
Maintenance	1,551,932	1,840,266
Depreciation and amortization	4,071,882	4,223,444
Other taxes	2,894,350	2,759,268
Income taxes	2,111,636	2,872,281
Total operating expenses	82,752,140	86,304,769
Operating Income	5,534,244	7,591,468
Other Income and Deductions	180,847	261,749
Income Before Interest Charges	5,715,091	7,853,217
Interest Charges	2,395,330	2,114,528
Net Income	\$3,319,761	\$5,738,689
Earnings Per Share of Common Stock (1):		
Primary:		
Earnings per share	\$0.74	\$1.30
Average shares outstanding	4,488,482	4,423,878
Fully Diluted:		
Earnings per share	\$0.73	\$1.26
Average shares outstanding	4,733,912	4,671,289

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

(1) See Exhibit 11 - Computation of Primary and Fully Diluted Earnings Per Share

**CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	For the Nine Months Ended September 30,	
	1997 (Unaudited)	1996 (As restated)
<b>Operating Activities</b>		
Net Income	\$3,319,761	\$5,738,689
Adjustments to reconcile net income to net operating cash		
Depreciation and amortization	4,575,567	4,934,216
Deferred income taxes, net	(275,145)	220,549
Investment tax credit adjustments	(36,231)	(36,231)
Employee benefits	363,597	328,412
Employee compensation from lapsing stock restrictions	130,181	257,204
Other	(1,109,270)	(420,383)
Changes in assets and liabilities:		
Accounts receivable	7,131,804	6,721,321
Inventory, materials, supplies and storage gas	(754,024)	(1,578,465)
Prepaid expenses	191,641	(157,759)
Other deferred charges	531,703	316,389
Accounts payable	(8,078,242)	(5,173,828)
Refunds payable to customers	(17,159)	(302,299)
Over/(Under) recovered purchased gas costs	1,988,614	(631,181)
Other current liabilities	336,226	474,175
Net cash provided by operating activities	<u>8,299,023</u>	<u>10,690,809</u>
<b>Investing Activities</b>		
Property, plant and equipment expenditures, net	<u>(9,565,768)</u>	<u>(9,372,957)</u>
Net cash used by investing activities	<u>(9,565,768)</u>	<u>(9,372,957)</u>
<b>Financing Activities</b>		
Common stock dividends net of amounts reinvested of \$409,920 and \$426,341, respectively	(2,716,123)	(2,168,446)
Net repayments under line of credit agreements	5,700,000	825,000
Proceeds from issuance of stock to Company 401(k) plan	298,028	260,126
Repayments of long-term debt	<u>(2,760,989)</u>	<u>(586,646)</u>
Net cash used by financing activities	<u>520,916</u>	<u>(1,669,966)</u>
<b>Net Decrease in Cash</b>	<u>(745,829)</u>	<u>(352,114)</u>
<b>Cash and Cash Equivalents at Beginning of Period</b>	<u>2,213,529</u>	<u>1,395,614</u>
<b>Cash and Cash Equivalents at End of Period</b>	<u>\$1,467,700</u>	<u>\$1,043,500</u>

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

be equitably entitled to contribution from other responsible parties for a portion of the expenses to be incurred in connection with the remedies selected in the ROD.

As of September 30, 1997, the Company has incurred approximately \$4.9 million in costs relating to environmental testing and remedial action studies. In 1990, the Company entered into settlement agreements with a number of insurance companies resulting in proceeds to fund actual environmental costs incurred over a five to seven-year period beginning in 1990. In December 1995, the Delaware Public Service Commission authorized a process to review and provide recovery of all current and future unrecovered environmental costs incurred by a means of a rider (supplement) to base rates, applicable to all firm service customers. As of September 30, 1997, \$966,000 of environmental costs are not included in the rider, effective December 1, 1996. With the rider mechanism established, it is management's opinion that these costs and any future costs, net of the deferred income tax benefit, will be recoverable in rates. For additional information pertaining to the rider, please refer to "Environmental -- Dover Gas Light Site" on page 15 of the Company's report on Form 10-K.

#### **Salisbury Town Gas Light Site**

In cooperation with the Maryland Department of the Environment ("MDE"), in 1996 the Company completed construction and began remediation procedures at the Salisbury site. In addition, the Company began quarterly reporting of the remediation and monitoring results to the MDE.

The cost of remediation is estimated to range from \$140,000 to \$190,000 per year for operating expenses. Based on these estimated costs, the Company recorded both a liability and a deferred regulatory asset of \$650,088 on December 31, 1996, to cover the Company's projected remediation costs for this site. The liability payout for this site is expected to be over a five-year period. As of September 30, 1997, the Company has incurred approximately \$2.3 million for remedial actions and environmental studies. In January 1990, the Company entered into settlement agreements with a number of insurance companies resulting in proceeds to fund actual environmental costs incurred over a three to five-year period beginning in 1990. The final insurance proceeds were requested and received in 1992. In December 1995, the Maryland Public Service Commission approved recovery of all environmental costs incurred through September 30, 1995 less amounts previously amortized and insurance proceeds. The amount approved for a 10-year amortization period was \$964,251. Of the \$2.3 million in costs reported above, approximately \$566,000 has not been recovered through insurance proceeds or received ratemaking treatment. It is management's opinion that these and any future costs incurred, will be recoverable in rates.

#### **Winter Haven Coal Gas Site**

In May 1996, the company filed an Air Sparging and Soil Vapor Extraction Pilot Study Work Plan for the Winter Haven site with the Florida Department of Environmental Protection ("FDEP"). The Work Plan described the Company's proposal to undertake an Air Sparging and Soil Vapor Extraction ("AS/SVE") pilot study to evaluate at the site. After discussions with the FDEP, the Company filed a modified AS/SVE Pilot Study Work Plan, scope of work to complete the site assessment activities and a report describing a limited sediment investigation performed recently. The Company will be awaiting FDEP's comments to the modified Work Plan. It is not possible to determine whether remedial action will be required by FDEP and, if so, the cost of such remediation.

The company has spent and received ratemaking treatment of approximately \$678,000 on these investigations as of September 30, 1997. The Company has been allowed by the Florida Public Service Commission to continue to accrue for future environmental costs. At September 30, 1997, the Company had \$432,000 accrued. It is management's opinion that future costs, if any, will be recoverable in rates.

mains. Depreciation and amortization expense increased due to plant placed in service during the past twelve months. Other taxes were higher due to revenue related taxes and property taxes.

### Natural Gas Transmission

The natural gas transmission segment reported EBIT of \$777,484 for the third quarter of 1997 as compared to EBIT of \$600,455 for the corresponding period last year — an increase of \$177,029. The increase in EBIT is primarily due to an increase in gross margin somewhat offset by higher expenses.

	FOR THE QUARTER ENDED SEPTEMBER 30,		
	<u>1997</u>	<u>1996</u>	<u>Change</u>
Revenue	\$ 6,857,335	\$ 6,701,703	\$ 155,632
Cost of Gas	5,078,678	5,109,832	(31,154)
Gross Margin	1,778,657	1,591,871	186,786
Operations & Maintenance	680,275	709,022	(28,747)
Depreciation & Amortization	223,928	185,249	38,679
Other Taxes	96,970	97,145	(175)
EBIT	<u>\$ 777,484</u>	<u>\$ 600,455</u>	<u>\$ 177,029</u>

The gross margin increase was primarily the result of a rate increase that went into effect mid-April. The higher rates resulted from of Eastern Shore Natural Gas Company's ("Eastern Shore") rate increase filing with the Federal Energy Regulatory Commission ("FERC"). Eastern Shore reached a settlement with FERC during the quarter, and any refund resulting from the settlement has been accrued, pending final approval. Operations expenses increased \$42,000, primarily in the areas of legal fees, outside services and corporate related costs offset by a decrease in payroll. Depreciation and amortization increased due to the capital additions placed in service during the past twelve months.

As previously reported, Eastern Shore filed with FERC an abbreviated application for a blanket certificate of public convenience to provide open access transportation service. Effective November 1, 1997, Eastern Shore initiated the provision of open access transportation services on its system. Eastern Shore will no longer sell gas, but has converted to a provider of contract storage and transportation services. Going forward, third party suppliers will compete with the Company to sell gas to the local distribution companies and the end users on Eastern Shore's system.

### Propane Distribution

For the third quarter of 1997, the propane distribution segment experienced LBIT of \$1,165,868. These results were more favorable than those achieved for the corresponding quarter of 1996, with the segment recognizing a decrease in LBIT of \$25,261 over the third quarter 1996 LBIT of \$1,191,129. The decrease in LBIT was attributable to lower operating expenses partially offset by a decrease in gross margin. The 1997 and 1996 financial results of the propane distribution segment include the operating results of Tri-County.

**RESULTS OF OPERATIONS FOR THE  
NINE MONTHS ENDED SEPTEMBER 30, 1997**

The Company recognized net income of \$3,319,761 for the nine months ended September 30, 1997, representing a decrease in net income of \$2,418,928 as compared to the corresponding period in 1996. The financial results for 1997 and 1996 include the operating results of Tri-County. As indicated in the table below, the decrease in EBIT is due to lower earnings in the natural gas and propane distribution segments, partially offset by increased earnings in transmission, advanced information services and other.

	FOR THE NINE MONTHS ENDED SEPTEMBER 30,		
	<u>1997</u>	<u>1996</u>	<u>Change</u>
<u>Earnings Before Interest and Taxes</u>			
Natural Gas Distribution	\$ 3,921,919	\$ 5,631,176	\$(1,709,257)
Natural Gas Transmission	2,091,774	1,797,540	294,234
Propane Distribution	224,979	1,886,140	(1,661,161)
Advanced Information Services	975,681	770,100	205,581
Eliminations & Other	431,527	378,793	52,734
Total EBIT	<u>7,645,880</u>	<u>10,463,749</u>	<u>(2,817,869)</u>
Operating Income Taxes	2,111,636	2,872,281	(760,645)
Interest	2,395,330	2,114,528	280,802
Non-Operating Income, Net	180,847	261,749	(80,902)
Net Income	<u>\$ 3,319,761</u>	<u>\$ 5,738,689</u>	<u>\$(2,418,928)</u>

**Natural Gas Distribution**

The natural gas distribution segment reported EBIT of \$3,921,919 for the first nine months of 1997 as compared to EBIT of \$5,631,176 for the corresponding period last year. The decrease in EBIT is due to a reduction in gross margin, coupled with increased expenses.

	FOR THE NINE MONTHS ENDED SEPTEMBER 30,		
	<u>1997</u>	<u>1996</u>	<u>Change</u>
Revenue	\$53,778,615	\$54,691,434	\$ (912,819)
Cost of Gas	<u>37,432,642</u>	<u>37,729,820</u>	<u>(297,178)</u>
Gross Margin	16,345,973	16,961,614	(615,641)
Operations & Maintenance	8,232,520	7,269,995	962,525
Depreciation & Amortization	2,371,871	2,324,536	47,335
Other Taxes	1,919,663	1,825,907	93,756
EBIT	<u>\$ 3,821,919</u>	<u>\$ 5,541,176</u>	<u>\$(1,719,257)</u>

The decrease in gross margin is primarily due to first quarter temperatures which were 14% warmer than the first quarter in 1996, resulting in an 11% reduction in deliveries during that period. Partially offsetting the decrease in margin was an \$89,000 increase in service work revenue. Operations expenses increased in the areas of billable service work, legal fees, outside services, data processing and regulatory related expenses. Maintenance expenses primarily increased in mains, meters and regulators. Depreciation and amortization expense increased due to plant placed in service during the last twelve months.



### Advanced Information Services

For the nine months ended September 30, the advanced information services segment recognized an EBIT of \$975,681 and \$770,100 for 1997 and 1996, respectively. This increase in EBIT of \$205,581 is the outcome of higher revenue and lower operating expenses.

	FOR THE NINE MONTHS ENDED SEPTEMBER 30,		
	<u>1997</u>	<u>1996</u>	<u>Change</u>
Revenue	\$ 5,954,733	\$ 5,482,677	\$ 472,056
Operations & Maintenance	4,641,232	4,395,184	246,048
Depreciation & Amortization	84,175	102,978	(18,803)
Other Taxes	253,645	214,415	39,230
EBIT	<u>\$ 975,681</u>	<u>\$ 770,100</u>	<u>\$ 205,581</u>

The increase in revenue occurred primarily in consulting and resource services due to a rise in demand for PROGRESS training and programmers. Operations expenses were higher due to billable compensation directly related to increases in revenue, non-billable compensation and other costs related to overall growth.

### Interest

The increase in interest expense is associated with higher short-term borrowing balances, as compared to the same period last year.

### Operating Income Taxes

Operating income taxes decreased \$760,645 due to a reduction in EBIT and the lack of income tax expense recorded by Tri-County in 1996, offset by a one-time expense of \$318,000 recorded during the first quarter. The one-time expense was required to establish deferred income taxes for Tri-County Gas Company, Inc., acquired during the first quarter of 1997. Prior to the acquisition, Tri-County Gas Company, Inc. was a Subchapter S Corporation for income tax reporting; therefore, no deferred income taxes were recorded on its balance sheet. In addition, the Company's 1996 restated financial statements do not include any income tax expense on EBIT reported for Tri-County due to its 1996 Subchapter S status.

### Non-Operating Income

The decrease in 1997 is related primarily to a reduction in interest income and AFUDC. In addition, 1996 includes a one-time gain on the sale of real property.

### Environmental Matters

The Company continues to work with federal and state environmental agencies to assess the environmental impacts and explore corrective action at several former gas manufacturing plant sites (see Note 4 to the Consolidated Financial Statements). The Company believes that any future costs associated with these sites will be recoverable in future rates.

**PART II**  
**OTHER INFORMATION**

**CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES**

- Item 1: Legal Proceedings  
See Note 2 to the Consolidated Financial Statements
- Item 2: Changes in Securities  
None
- Item 3: Defaults Upon Senior Securities  
None
- Item 4: Submission of Matters to a Vote of Security Holders  
None
- Item 5: Other Information  
None
- Item 6(a): Exhibits  
Exhibit 11 - Computation of Primary and Fully Diluted Earnings Per Share is submitted herewith.
- Item 6 (b): Reports on Form 8-K  
None

# CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES

## EXHIBIT 11 COMPUTATION OF PRIMARY AND FULLY DILUTED EARNINGS PER SHARE

	For the Quarter Ended September 30, (1)		For the Nine Months Ended September 30,	
	1997	1996	1997	1996
Primary earnings per share calculation:				
Weighted average number of shares	4,502,279	4,442,713	4,488,482	4,423,878
Consolidated net income	(\$739,193)	(\$747,779)	\$3,319,761	\$5,738,689
Primary earnings per share	(\$0.16)	(\$0.17)	\$0.74	\$1.30
Fully diluted earnings per share calculation:				
Weighted average number of shares	4,507,798	4,445,501	4,493,708	4,427,862
Contingent shares related to assumed conversion of convertible debt	239,939	242,171	240,204	243,427
Weighted average number of shares assuming full dilution	4,747,737	4,687,672	4,733,912	4,671,289
Adjusted income				
Consolidated net income	(\$739,193)	(\$747,779)	\$3,319,761	\$5,738,689
Interest on convertible debt	84,882	85,438	252,157	255,775
Less: Applicable income taxes	(33,104)	(33,321)	(98,341)	(99,752)
Adjusted net income	(\$687,415)	(\$695,662)	\$3,473,577	\$5,894,712
Fully diluted earnings per share	(\$0.14)	(\$0.15)	\$0.73	\$1.26

(1) This calculation is submitted in accordance with Regulation S-K item 601(b)(11), although it is contrary to paragraph 40 of APB Opinion No. 15, because it produces an anti-dilutive result for the quarters ended September 30, 1997 and 1996.

**CHESAPEAKE UTILITIES CORPORATION**  
**Schedule No. 2**  
**Rate of Return, Actual Annualized and Pro Forma**  
**For the Twelve Months Ended September 30, 1997**

**UNAUDITED**

	<u>ACTUAL BEFORE ISSUANCE</u>	<u>ADJUSTMENT</u>	<u>PRO FORMA BEFORE ISSUANCE</u>	<u>ISSUANCE OF COMMON STOCK</u>	<u>PRO FORMA AFTER ISSUANCE OF EQUITY</u>
<u>Statement of Income</u>					
1 Operating revenues	\$124,669,424	\$0	\$124,669,424	\$1,539,638	\$126,209,062
2 Operating expenses before income taxes	\$113,430,232	\$0	\$113,430,232	\$1,416,291	\$114,846,523
3 Income taxes (Including Deferrals)	\$3,186,411	\$0	\$3,186,411	\$34,730	\$3,221,141
4 Operating Income (1-(2+3))	\$8,052,781	\$0	\$8,052,781	\$88,617	\$8,141,398
5 AFUDC (Equity Only)	\$101,384	\$0	\$101,384	\$0	\$101,384
6 Other Income, Net	\$275,963	\$0	\$275,963	\$1,290	\$277,253
7 Income Before Interest Charges (4+5+6)	\$8,430,128	\$0	\$8,430,128	\$89,907	\$8,520,035
8 Interest Charges (Including debt portion of AFUDC)	\$3,244,141	\$122,320	\$3,366,461	\$36,522	\$3,402,983
9 Net Income From Continuing Operations (7-8)	\$5,185,987	(\$122,320)	\$5,063,667	\$53,385	\$5,117,052
10 Preferred stock dividends	\$0	\$0	\$0	\$0	\$0
11 Earnings available to common equity (9-10)	\$5,185,987	(\$122,320)	\$5,063,667	\$53,385	\$5,117,052
12 Average capitalization	\$77,698,787	\$10,000,000	\$87,698,787	\$195,536	\$87,894,323
13 Average common equity	\$48,455,505	\$0	\$48,455,505	\$195,536	\$48,651,041
14 Return on average capitalization (7/12)	10.85%		9.61%		9.69%
15 Return on average common equity (11/13)	10.70%		10.45%		10.52%

RESAR E UT S C ORA  
Schedule No. 1  
Capitalization Ratios Actual & Pro Forma as of September 30, 1997

UNAUDITED

	ACTUAL BEFORE ISSUANCE			PRO FORMA BEFORE ISSUANCE			PRO FORMA AFTER ISSUANCE OF EQUITY	
TYPE OF CAPITAL	AMOUNT OUTSTANDING	% OF TOTAL	ADJUSTMENT	AMOUNT OUTSTANDING	% OF TOTAL	ISSUANCE OF COMMON STOCK	AMOUNT OUTSTANDING	% OF TOTAL
COMMON EQUITY								
COMMON STOCK	\$2,181,014	2.27%	\$0	\$2,181,014	2.27%	\$16,061	\$2,197,075	2.27%
PAID IN CAPITAL	19,433,279	20.22%	0	19,433,279	20.22%	34,939	19,468,218	20.08%
RETAINED EARNINGS	26,777,950	27.87%	0	26,777,950	27.87%	144,536	26,922,486	27.77%
TOTAL COMMON EQUITY	48,392,243	50.36%	0	48,392,243	50.36%	195,536	48,587,779	50.12%
PREFERRED STOCK	0	0.00%	0	0	0.00%	0	0	0.00%
LONG-TERM DEBT								
FIRST MORTGAGE BONDS	4,560,000	4.75%	0	4,560,000	4.75%	0	4,560,000	4.70%
CONVERTIBLE DEBENTURES	4,082,000	4.25%	0	4,082,000	4.25%	0	4,082,000	4.21%
OTHER LONG-TERM DEBT	20,000,000	20.81%	10,000,000	30,000,000	31.22%	0	30,000,000	30.95%
TOTAL LONG-TERM DEBT	28,642,000	29.81%	10,000,000	38,642,000	40.22%	0	38,642,000	39.86%
TOTAL PERMANENT CAPITAL	77,034,243	80.17%	10,000,000	87,034,243	90.58%	195,536	87,229,779	89.98%
CURRENT PORTION OF LTD	659,868	0.69%	0	659,868	0.69%	0	659,868	0.68%
SHORT-TERM DEBT	18,400,000	19.14%	(10,000,000)	8,400,000	8.73%	649,076	9,049,076	9.34%
TOTAL CAPITALIZATION	\$96,094,111	100.00%	\$0	\$96,094,111	100.00%	\$844,612	\$96,938,723	100.00%

## CHESAPEAKE UTILITIES CORPORATION

Schedule No. 3

Fixed Charge Coverage Ratios

For the Twelve Months Ended September 30, 1997

UNAUDITED

<u>Type of Method</u>	<u>HISTORICAL</u>		<u>ANNUALIZED</u>	
	<u>ACTUAL BEFORE ISSUANCE</u>	<u>PRO FORMA AFTER ISSUANCE OF EQUITY</u>	<u>PRO FORMA BEFORE ISSUANCE</u>	<u>PRO FORMA AFTER ISSUANCE OF EQUITY</u>
<u>Per Financial Statements</u>				
Before Income Taxes, all interest	3.4323	3.4273	3.3482	3.3146
Before Income Taxes, all interest, before AFUDC	3.4026	3.3979	3.3195	3.2863
After Income Taxes, all interest	1.5187	1.5216	1.4662	1.4319
After Income Taxes, all interest, before AFUDC	1.4890	1.4923	1.4376	1.4036
Overall Coverage, (after income taxes)	1.5187	1.5216	1.4662	1.4319
Overall Coverage, (after income taxes) before AFUDC	1.4890	1.4923	1.4376	1.4036
<u>Modified Indenture Method</u>				
Before Income Taxes, all interest	3.9611	3.9480	3.8039	3.7993
Before Income Taxes, all interest, before AFUDC	3.9269	3.9142	3.7710	3.7668
After Income Taxes, all interest	1.8451	1.8439	1.7322	1.7290
After Income Taxes, all interest, before AFUDC	1.8109	1.8101	1.6993	1.6965
Overall Coverage, (after income taxes)	1.8451	1.8439	1.7322	1.7290
Overall Coverage, (after income taxes) before AFUDC	1.8109	1.8101	1.6993	1.6965

## STATE OF DELAWARE

## BEFORE THE PUBLIC SERVICE COMMISSION

IN THE MATTER OF THE APPLICATION	)	
OF CHESAPEAKE UTILITIES CORPORATION	)	
FOR APPROVAL OF THE ISSUANCE OF	)	PSC DOCKET NO. 98-86
25,000 SHARES OF COMMON STOCK	)	
(FILED MARCH 2, 1998 AND	)	
AMENDED MARCH 17, 1998)	)	

ORDER NO. 4758

AND NOW, to-wit, on this 24th day of March, 1998, the Applicant, Chesapeake Utilities Corporation ("Chesapeake" or the "Company"), having sought Commission approval to issue 25,000 shares of Chesapeake common stock for the purpose of consummating the acquisition by the Company, acting through a subsidiary (CPK Sub-B), of all of the issued and outstanding common stock of Sam Shannahan Well Company, Inc., d/b/a Tolan Water Service ("SSWC"), presently a family-owned company specializing in residential, commercial, and industrial water treatment systems and irrigation headquartered in Salisbury, Maryland, pursuant to an Agreement and Plan of Merger (the "Merger Agreement") filed with the above-referenced application;

AND, after the consummation of the merger, the surviving company continuing to use the name SSWC will be operated as a subsidiary of Chesapeake;

AND, the Commission having examined the Company's original and amended application and having made such investigation in connection with said matters as the Commission deemed necessary, and having heard the presentation of the Company and the Commission Staff at the Commission meeting of March 24, 1998;

AND, the Commission having been advised by Staff of certain concerns that Staff has regarding said merger and its potential effect on ratepayers of the Delaware Division of Chesapeake and the Company having agreed to said conditions;

AND, the Commission having been advised, and having determined, that the proposed issuance of 25,000 shares of Chesapeake common stock to consummate the Merger Agreement is in accordance with law, for a proper purpose, and consistent with the public interest; now, therefore,

**IT IS ORDERED THAT:**

1. The application filed by Chesapeake Utilities Corporation in this matter on or about March 2, 1998, and amended on March 17, 1998, is hereby approved, and Chesapeake Utilities Corporation is hereby authorized to issue up to 25,000 shares of



Chesapeake common stock to consummate the above-described acquisition of Sam Shannahan Well Company, Inc.

2. Said approval is based upon Chesapeake's representation and guarantee: (1) that no expenses associated with this transaction shall be recovered, in the future, in rates from Delaware Division ratepayers; and (2) that the Company will quantify and allocate to Delaware Division ratepayers those savings in corporate overhead expenses that may be achieved through and as a result of said transaction.

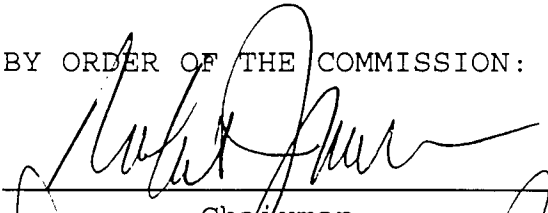
3. Approval of Chesapeake's application by the Commission shall not be construed as approving any capitalization ratios that result for any purposes or procedures involving ratemaking; nor are the Commission's rules regarding the burden of proving the merits of any related issue waived hereby. The Commission's approval of Chesapeake's application is limited to that which is necessary under 26 Del. C. § 215.

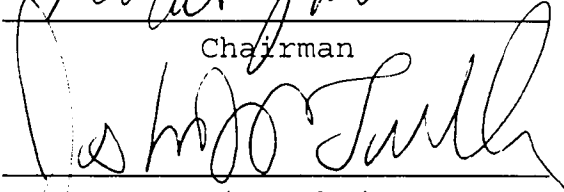
4. Nothing in this Order shall be construed as a guarantee, warranty, or representation by the State of Delaware or by any agency, commission, or department hereof, with respect to the shares to be issued pursuant to the Merger Agreement and this Order.

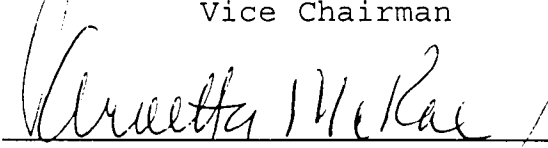
5. Chesapeake shall file with this Commission a written report within sixty (60) days of the closing of the merger transaction setting forth the steps which have been taken in connection with such transaction including, but not limited to, the resulting capitalization ratios arising from the issuance of Chesapeake's common stock.

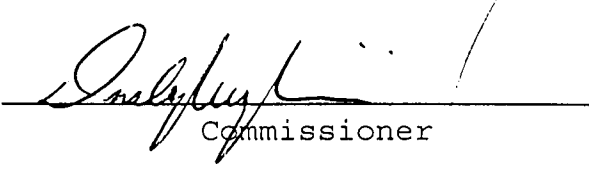
6. The Commission reserves the jurisdiction and authority to enter such further Orders in this matter as may be deemed necessary or proper.


BY ORDER OF THE COMMISSION:

  
Chairman

  
Vice Chairman

  
Commissioner

  
Commissioner

  
Commissioner

ATTEST:

  
Secretary

## AGREEMENT AND PLAN OF MERGER

THIS AGREEMENT AND PLAN OF MERGER (the "Agreement") is made and entered into as of April 28, 1998, by and among Chesapeake Utilities Corporation, a Delaware corporation ("Chesapeake"), CPK Sub-C, Inc., a Delaware corporation and a wholly owned subsidiary of Chesapeake ("CPK-Sub-C"), Xeron, Inc., a Mississippi corporation ("Xeron"), J. Phillip Keeter, Earnest A. Allen, Jr. and Patrick E. Armand, residents of Texas (each individually a "Shareholder," together, the "Shareholders," and with Xeron collectively, the "Sellers").

### ARTICLE I THE MERGER

SECTION 1.1 The Merger. Upon the terms and subject to the conditions hereof, as promptly as practicable following the satisfaction or waiver of the conditions set forth in Article VIII hereof, but in no event later than two business days thereafter, unless the parties hereto shall otherwise agree, articles of merger (the "Articles of Merger") and a certificate of merger (the "Certificate of Merger") providing for the merger of CPK-Sub-C with and into Xeron (the "Merger") shall be duly prepared, executed and filed by Xeron, as the surviving corporation (the "Surviving Corporation"), in accordance with the relevant provisions of the Mississippi General Corporation Law (the "MGCL") and the Delaware General Corporation Law (the "DGCL") and the Merger shall become effective. Following the Merger, the Surviving Corporation shall continue under the same name as Xeron and the separate corporate existence of CPK-Sub-C shall cease. The date and time the Merger becomes effective is referred to herein as the "Effective Time." Immediately prior to the filing of the Articles of Merger and the Certificate of Merger, a closing (the "Closing") shall take place at the offices of Xeron in Houston, Texas or at such other place and at such time as the parties shall agree.

SECTION 1.2 Effects of the Merger. The Merger shall have the effects set forth in Section(s) 79-4-11.01 through 79-4-11.07 of the MGCL and Sections 259, 260 and 261 of the DGCL.

SECTION 1.3 Certificate of Incorporation and By-Laws. The Articles of Incorporation of Xeron and the By-laws of CPK-Sub-C (both of which have been heretofore delivered by Xeron to Chesapeake or Chesapeake to Xeron, as the case may be), in each case as in effect immediately prior to the Effective Time, shall be the Articles of Incorporation and By-laws of the Surviving Corporation until duly amended in accordance with applicable law.

SECTION 1.4 Directors. The directors of CPK-Sub-C immediately prior to the Effective Time shall be the initial directors of the Surviving Corporation and shall hold office until their respective successors are duly elected and qualified in accordance with the Articles of Incorporation and By-laws of the Surviving Corporation, or their earlier death, resignation or removal.

SECTION 1.5 Officers. The officers of CPK-Sub-C immediately prior to the Effective Time shall be the initial officers of the Surviving Corporation and shall serve as the officers of the Surviving Corporation at the pleasure of the Board of Directors of the Surviving Corporation.

SECTION 1.6 Conversion of Shares. At the Effective Time, by virtue of the Merger and without any action on the part of the holders thereof:

(a) Subject to Section 2.2, each issued and outstanding share of common stock, par value \$10.00 per share, of Xeron (the "Xeron Common Stock") shall automatically be converted into the right to receive (the "Stock Consideration") that number of fully paid and nonassessable shares of common stock, par value \$.4867 per share, of Chesapeake (the "Chesapeake Common Stock"), which shall be determined by dividing a total of 475,000 shares of Chesapeake Common Stock by the aggregate number of shares of Xeron Common Stock outstanding at the Effective Time, provided that in the event of a stock split or reverse stock split of the Chesapeake Common Stock prior to the Effective Time, the number of shares of Chesapeake Common Stock to be issued shall be adjusted proportionately to prevent either dilution or enlargement of the rights of the Shareholders.

(b) Each share of capital stock of Xeron that is held in the treasury of Xeron shall be canceled and retired and cease to exist and no consideration shall be issued in exchange therefor.

(c) The issued and outstanding shares of capital stock of CPK-Sub-C shall be converted into and become, in the aggregate, one thousand fully paid and nonassessable shares of common stock of the Surviving Corporation.

## ARTICLE II EXCHANGE OF SHARES

SECTION 2.1 Surrender of Certificates. At the Effective Time, each of the Shareholders shall surrender the certificate or certificates that formerly represented that Shareholder's shares of Xeron Common Stock to the Surviving Corporation, and shall thereupon receive in exchange therefor the Stock Consideration for each share of Xeron Common Stock formerly represented by such certificate or certificates, and the certificates so surrendered shall forthwith be cancelled.

SECTION 2.2 No Fractional Shares. No certificate or scrip representing fractional shares of Chesapeake Common Stock shall be issued upon the surrender for exchange of certificates of Xeron Common Stock, and such fractional share interests will not entitle the owner thereof to vote or to any rights of a shareholder of Chesapeake. In lieu of any such fractional share interest, Chesapeake shall pay to each shareholder of

Xeron who otherwise would be entitled to receive a fractional share of Chesapeake Common Stock (after aggregating all certificates formerly representing shares of Xeron Common Stock held by the same holder) an amount of cash determined by multiplying (i) the average of the closing prices of Chesapeake Common Stock on the New York Stock Exchange ("NYSE"), as reported by The Wall Street Journal, for the twenty (20) consecutive trading days immediately preceding the second day prior to the Effective Time, by (ii) the fraction of a share of Chesapeake Common Stock to which such holder would otherwise be entitled pursuant to Section 1.6(a) of this Agreement.

### ARTICLE III REPRESENTATIONS AND WARRANTIES OF THE SELLERS

Each of the Sellers represents and warrants to Chesapeake and CPK-Sub-C as follows:

#### SECTION 3.1 Corporate Organization.

(a) Xeron is a corporation duly organized, validly existing and in good standing under the laws of the State of Mississippi and has all requisite corporate power and authority to own, lease and operate its properties and to carry on its business as now being conducted. Section 3.1(a) of the disclosure schedule to be delivered to Chesapeake prior to the date of this Agreement (the "Xeron Disclosure Schedule") sets forth the name of each jurisdiction in which Xeron is qualified or licensed to do business. Xeron is duly qualified or licensed to do business and is in good standing in each jurisdiction in which the property owned, leased or operated by it or the nature of the business conducted by it makes such qualification or licensing necessary unless failure to qualify would not result in a material adverse effect on Xeron. Xeron has heretofore delivered to Chesapeake accurate and complete copies of its Certificate of Incorporation and By-laws, as in effect as of the date of this Agreement.

(b) Xeron does not own, directly or indirectly, any capital stock or other equity securities or similar interest in any corporation, partnership, joint venture, or other business association or entity except as set forth in Section 3.1(b) of the Xeron Disclosure Schedule.

SECTION 3.2 Capitalization. The authorized capital stock of Xeron consists of 7500 shares of Xeron Common Stock, of which 6750 shares are issued and outstanding. All of the issued and outstanding shares of Xeron Common Stock are validly issued, fully paid and nonassessable. There are no subscriptions, options, warrants, calls, rights, convertible securities or other agreements or commitments of any character (whether or not currently exercisable) obligating Xeron to issue, transfer or sell any of its securities. Section 3.2 of the Xeron Disclosure Schedule sets forth (i) the name

of the holder and beneficial owner of each outstanding share of Xeron Common Stock, and (ii) the number of shares of Xeron Common Stock held by such holder.

SECTION 3.3 Authority Relative to this Agreement; Binding Effect.

(a) Xeron has full corporate power and authority to execute and deliver this Agreement and to consummate the transactions contemplated hereby. The execution and delivery of this Agreement and the consummation of the transactions contemplated hereby have been duly and validly authorized and approved by the Board of Directors of Xeron and by the unanimous vote or written consent of the shareholders of Xeron and no other corporate proceedings on the part of Xeron are necessary to authorize this Agreement or to consummate the transactions so contemplated. This Agreement has been duly and validly executed and delivered by Xeron and constitutes a legal, valid and binding agreement of Xeron, enforceable against Xeron in accordance with its terms.

(b) This Agreement has been duly and validly executed and delivered by each Seller and constitutes a legal, valid and binding agreement of each Seller, enforceable against each Seller in accordance with its terms.

SECTION 3.4 Consents and Approvals; No Violations. Except for the filing and recordation of the Articles of Merger, as required by the MGCL, and the Certificate of Merger, as required by the DGCL, and as set forth in Section 3.4 of the Xeron Disclosure Schedule, no filing with or notification to, and no permit, authorization, consent, waiver or approval of, any government, executive official thereof, governmental or regulatory authority, agency, commission, or court of competent jurisdiction, domestic or foreign (a "Governmental Entity"), is necessary for the consummation by the Sellers of the transactions contemplated by this Agreement. Except as set forth in Section 3.4 of Xeron Disclosure Schedule, neither the execution and delivery of this Agreement by the Sellers nor the consummation by the Sellers of the transactions contemplated hereby nor compliance by the Sellers with any of the provisions hereof will (i) conflict with or result in any breach of any provision of the Articles of Incorporation or By-laws of Xeron, (ii) result in a violation or breach of, or constitute (with or without due notice or lapse of time or both) a default (or give rise to any right of termination, cancellation or acceleration or result in the creation of any mortgage, pledge, charge, security interest, claim or encumbrance of any kind (collectively, a "Lien")) under, any of the terms, conditions or provisions of any note, bond, mortgage, indenture, license, contract, agreement or other instrument or obligation to which any Seller is a party or by which it or any of its properties or assets may be bound, or (iii) violate any order, writ, injunction, decree, statute, rule or regulation applicable to the Sellers or any of their properties or assets.

SECTION 3.5 Absence of Certain Changes. Except as and to the extent set forth in Section 3.5 of the Xeron Disclosure Schedule, since November 30, 1997 Xeron has not:

(a) suffered any Material Adverse Change; "Material Adverse Change" means (i) any material change in the nature of Xeron's business, assets, financial condition, results of operations, or prospects, (ii) the loss of a material contract (other than spot contracts which have been performed by the parties thereto in accordance with their terms), and (iii) any change that creates a material limitation on the ability of Xeron to conduct its business as heretofore conducted;

(b) paid, discharged or otherwise satisfied any material claims, liabilities or obligations (absolute, accrued, contingent or otherwise) other than the payment, discharge or satisfaction in the ordinary course of business and consistent with past practice;

(c) permitted or allowed any of its material property or assets (real, personal or mixed, tangible or intangible) to be subjected to any Liens, except for (i) Liens for current taxes or other governmental charges not yet due and payable, or the amount or validity of which is being contested by the appropriate proceedings and for which an appropriate reserve has been established and is reflected in the Financial Statements (as defined below), (ii) Liens disclosed in Sections 3.23(b) and 3.23(c) of the Xeron Disclosure Schedule, (iii) Liens of carriers, warehousemen and mechanics and similar Liens incurred in the ordinary course of business, and (iv) zoning, entitlement and other land use regulations (collectively, "Permitted Liens");

(d) sold, transferred, or otherwise disposed of any of its properties or assets (real, personal or mixed, tangible or intangible), except in the ordinary course of business and consistent with past practice;

(e) granted any increase in the compensation or benefits of any director, officer or employee (including any such increase pursuant to any bonus, pension, profit sharing or other plan or commitment) or any increase in the compensation or benefits payable or to become payable to any director, officer or employee, and no such increase is customary on a periodic basis or required by agreement or understanding;

(f) made any change in Xeron's severance policy or practices;

(g) made any expenditure capitalized in accordance with generally accepted accounting principles or acquired any property or assets for a cost in excess of \$25,000, in the aggregate, other than in the ordinary course of business;

(h) declared, paid or set aside for payment any dividend or other distribution in respect of its capital stock or redeemed, purchased or otherwise acquired, directly or indirectly, any shares of capital stock or other securities of Xeron;

(i) made any change in any method of tax or financial accounting or accounting practice or made or changed any election for Federal income tax purposes;

(j) paid, loaned or advanced any amount to, or sold, transferred or leased any properties or assets (real, personal or mixed, tangible or intangible) to, or entered into any agreement or arrangement with, any of its officers, directors or shareholders or any affiliate or associate of any of its officers, directors or shareholders except for directors' fees, and compensation to officers at rates not exceeding the rates of compensation paid during the six month period immediately prior to November 30, 1997;

(k) agreed or planned, whether in writing or otherwise, to take any action described in this Section.

SECTION 3.6 Financial Statements. Xeron shall have furnished to Chesapeake prior to the date of this Agreement audited balance sheets for the last two completed fiscal years, audited statements of income, equity and cash flows of Xeron for the last three completed fiscal years and an unaudited balance sheet and statement of income for the nine month period ending February 28, 1998 (collectively, the "Financial Statements"). The audited financial statements are true, correct and complete in all material respects, fairly present, in conformity with generally accepted accounting principles applied on a consistent basis (except as may be indicated in Section 3.6 of the Xeron Disclosure Schedule) the financial position of Xeron as of the dates thereof and its consolidated results of operations and changes in financial position and changes in stockholders equity and cash flows for the periods then ended. Such unaudited balance sheet and statement of income shall be certified by the Chief Executive Officer of Xeron as having been prepared under his supervision; as presenting the financial position of Xeron in accordance with generally accepted accounting principles consistently applied (except as may be indicated in Section 3.6 of the Xeron Disclosure Schedule); to be true, correct and complete in all material respects; and to reflect accurately the results of operations of Xeron for such nine month period.

SECTION 3.7 No Undisclosed Liabilities. Except as and to the extent provided in the Financial Statements or Section 3.7 of the Xeron Disclosure Schedule, Xeron does not have any material liabilities (whether contingent or absolute, direct or indirect, known or unknown to Xeron or matured or unmatured) not fully reflected or fully reserved against in the Financial Statements. Except as set forth in Section 3.7 of the Xeron Disclosure Schedule, since November 30, 1997, Xeron has not incurred any liability except in the ordinary course of business consistent with past practice.

SECTION 3.8 No Default. Except as set forth in Section 3.8 of the Xeron Disclosure Schedule, Xeron is not in default or violation (and no event has occurred that with notice or the lapse of time or both would constitute a default or violation) of any term, condition or provision of (i) its Certificate of Incorporation or its



By-laws, (ii) any note, bond, mortgage, indenture, license, contract, agreement or other instrument or obligation to which Xeron is a party or by which it or any of its properties or assets are bound, or (iii) any order, writ, injunction, decree, statute, rule or regulation applicable to Xeron or any of its properties or assets, unless any such default or violation would not have a material adverse effect on Xeron.

SECTION 3.9 Litigation. Except as set forth in Section 3.9 of the Xeron Disclosure Schedule, there is no action, suit, proceeding, arbitration, or investigation pending or, to the knowledge of Xeron, threatened involving Xeron or any of its properties or assets. Neither Xeron nor any of its properties or assets is subject to any order, writ, judgment, injunction, decree, determination or award. There is no action, suit, proceeding, arbitration or investigation initiated by Xeron that is currently pending or that Xeron presently intends to initiate.

SECTION 3.10 Compliance with Applicable Law. Except as set forth in Section 3.10 of the Xeron Disclosure Schedule, the business of Xeron has not been conducted in violation of any applicable law, ordinance, rule, regulation, decree or order of any Governmental Entity, unless such violation will not result in a material adverse effect on Xeron. Xeron holds all permits, licenses, variances, exemptions, orders and approvals of all Governmental Entities necessary for the lawful conduct of its businesses (the "Xeron Permits") and is in compliance with the terms of the Xeron Permits, unless the failure to obtain any Xeron Permits or be in compliance therewith will not result in a material adverse effect on Xeron. Except as set forth in Section 3.10 of the Xeron Disclosure Schedule, Xeron has not received any notification of any asserted present or past failure by Xeron to comply with such laws, rules or regulations or such Xeron Permits which have not been previously cured, and there is, to the knowledge of Xeron, no pending audit, investigation or other review by any Governmental Entity to determine the existence of any violation of such laws, rules or regulations or such Xeron Permits.

#### SECTION 3.11 Taxes.

(a) Since June 1, 1979, Xeron has been a C corporation for purposes of the Internal Revenue Code of 1986, as amended, and the rules and regulations promulgated thereunder (the "Code").

(b) The amounts, if any, provided as a liability on the Financial Statements for all Taxes (as hereinafter defined) ("tax liability amounts") are adequate to cover all unpaid liabilities for all Taxes, whether or not disputed, that have accrued or will accrue with respect to or are applicable to the period ended on and including the Effective Time (including, without limitation, as a result of the transactions contemplated by this Agreement) or to any years and periods prior thereto and for which Xeron may be directly or contingently liable in its own right or as a transferee of the assets of, or successor to, any person; provided, however, that with respect to tax liability amounts reflected on the unaudited financial statements for the nine-month period ending February

28, 1998, the term "adequate" means that such amounts are reasonable estimates made in good faith based on currently available information. Except as set forth in Section 3.11(b) of the Xeron Disclosure Schedule, Xeron has incurred no Tax liabilities other than in the ordinary course of business for any taxable year for which the applicable statute of limitations has not expired. There are no Liens for Taxes (other than Liens for current Taxes not yet due and payable, or the amount or validity of which is being contested by the appropriate proceedings and for which an appropriate reserve has been established and is reflected in the Financial Statements) upon the properties or assets of Xeron. Xeron has not granted or been requested to grant any waiver of any statutes of limitations applicable to any claim for Taxes. Xeron has made no elections for federal income tax purposes, except for customary elections for inventory, amortization and depreciation.

(c) Xeron (i) has filed (or has had filed on its behalf) or has caused to be filed timely all Tax Returns (as hereinafter defined) required by applicable law to be filed and (ii) has paid all Taxes shown thereon as owing. To the knowledge of Xeron, each such Tax Return is true, accurate and complete and Xeron has paid all Taxes as are due, except such as are being contested in good faith by appropriate proceedings and with respect to which Xeron is maintaining reserves adequate for their payment. All Taxes that Xeron is required by law to withhold or collect, including sales and use taxes, and amounts required to be withheld for Taxes of employees and other withholding taxes, have been duly withheld or collected and, to the extent required, have been paid over in a timely manner to the proper governmental authorities or are held in separate bank accounts for such purpose.

(d) No extensions of time have been granted for Xeron to file any Tax Return required by applicable law to be filed, which have expired, without such Tax Return having been filed.

(e) Except as disclosed in Section 3.11(e) of the Xeron Disclosure Schedule, none of the Tax Returns filed by or on behalf of Xeron are currently undergoing any Audit (as hereinafter defined), Xeron has received no notice that any Tax Return will undergo any Audit, and no facts exist that would constitute grounds for the assessment against Xeron of any material additional Taxes by any governmental authority for periods that have not been audited. No material issues have been raised in any Audit by any governmental authority with respect to the business and operations of Xeron that, by application of similar principles, reasonably could be expected to result in a proposed adjustment to the liability for Taxes for any other period not so examined. No deficiency or adjustment for any Taxes has been threatened, proposed, asserted, or assessed against Xeron.

(f) No power of attorney has been granted by Xeron with respect to any matter relating to Taxes which is currently in force.

(g) Xeron is not a party to any agreement providing for the allocation or sharing of Taxes.

(h) Xeron has not entered into any agreement that would result in the disallowance of any tax deduction pursuant to Code Section 280G.

(i) No "consent" within the meaning of Code Section 341(f) has been filed with respect to Xeron.

(j) Except as disclosed in Section 3.11(j) of the Xeron Disclosure Schedule, Xeron is not subject to any arrangement that (a) gives rise to a deduction or loss before the Effective Time and a corresponding recognition of taxable gain or income after the Effective Time or (b) gives rise to the recognition of taxable income or gain after the Effective Time without the receipt of a corresponding amount of cash.

(k) None of the Shareholders is a "foreign person" as defined in Code Section 1445(f)(3).

(l) None of the assets of Xeron constitutes tax-exempt bond financed property or tax-exempt use property within the meaning of Code Section 168, and none of the assets reflected on the Financial Statements is subject to a lease, safe harbor lease or other arrangement as a result of which Xeron is not treated as the owner of such assets for federal income tax purposes.

(m) The basis of all depreciable or amortizable assets, and the methods used in determining allowable depreciation or amortization (including cost recovery) deductions of Xeron, are materially correct and in compliance with the Code.

(n) To the knowledge of Xeron, Xeron is not required to make any material adjustment under Code Section 481(a) by reason of a change or proposed change in accounting method or otherwise.

(o) For purposes of this Section:

(i) the term "Taxes" shall mean all taxes, charges, fees, duties (including customs duties), levies or other assessments, including income, gross receipts, net proceeds, ad valorem, turnover, real and personal property (tangible and intangible), sales, use, franchise, excise, value added, stamp, leasing, lease, user, transfer, fuel, excess profits, occupational, interest equalization, windfall profits, severance, license, payroll, environmental, capital stock, disability, employee's income withholding, other withholding, unemployment and Social Security taxes, which are imposed by any federal, state, local or foreign

governmental authority, and such term shall include any interest, penalties or additions to tax attributable thereto;

(ii) the term "Tax Return" shall include all federal, state, local and foreign tax returns, declarations, statements, reports, schedules, forms and information returns and any amended Tax Return relating to Taxes; and

(iii) the term "Audit" shall include any taxing authority's audit, assessment of Taxes, or other examination proceedings or appeal of such proceedings relating to Taxes.

### SECTION 3.12 Benefit Plans and Arrangements

(a) Section 3.12(a) of the Xeron Disclosure Schedule contains a list of all employee benefits, plans or arrangements (whether or not subject to the Employee Retirement Income Security Act of 1974, as amended, and the rules and regulations promulgated thereunder ("ERISA"), and whether written or oral) that Xeron has maintained or to which it has contributed at any time for the benefit of its employees (the "Employee Benefit Plans").

(b) Xeron has provided Chesapeake with a true and complete copy of each of the following for the Employee Benefit Plans which are currently in effect: the current plan document, including any amendments thereto, the most recent summary plan description, annual reports on form 5500 for the three most recent years (if such forms were required to be filed), and any trust agreements, insurance contracts, service provider agreements or similar agreements. Xeron has no plan or commitment, whether legally binding or not, to create any additional benefit plans or arrangements or to change the terms of the Employee Benefits Plans.

(c) Xeron has complied in all material respects with all applicable provisions of ERISA and the Code and all other applicable laws, rules, and regulations with respect to the Employee Benefit Plans except for compliance failure(s) that individually or in the aggregate would not have a material adverse effect on Xeron. The Employee Benefit Plans are not subject to any ongoing audit or other administrative proceeding of any governmental entity, and are not the subject of any pending application for administrative relief under any program of the IRS, the Department of Labor, or any other governmental entity. Xeron has disclosed in Section 3.12(c) of the Xeron Disclosure Schedule all material liabilities with respect to the Employee Benefit Plans to Chesapeake. There are no pending or threatened claims (other than routine claims for benefits) against the Employee Benefit Plans by any person. The Employee Benefit Plans are not multiemployer plans within the meaning of ERISA except as set forth in Section 3.12(c) of the Xeron Disclosure Schedule. The Employee Benefit Plans can be terminated, without penalty, with no requirement for the further provision of benefits.

within a period of 30 days. None of the representations in this Section will be affected by the occurrence of the Merger.

#### SECTION 3.13 Environmental Matters.

(a) Except as set forth in Section 3.13 of the Xeron Disclosure Schedule, neither Xeron nor any Shareholder has learned, been advised, or received any communication (written or oral), whether from a governmental authority, citizens group, employee or otherwise that alleges or suggests that Xeron or any Shareholder is not in full compliance with the Environmental Laws. Section 3.13 of the Xeron Disclosure Schedule lists the permits or other governmental authorizations that Xeron has pursuant to the Environmental Laws.

(b) To the knowledge of Xeron, there are no Environmental Claims (as hereinafter defined) pending or threatened against Xeron or any Shareholder or against any person or entity whose liability for any Environmental Claim Xeron or any Shareholder has retained, or has assumed either contractually or by operation of law and neither Xeron nor any Shareholder knows of any facts or allegations that could result in future Environmental Claims.

(c) To the knowledge of Xeron, none of the Real Property, as such term is defined in Section 3.23, nor any property owned or leased by Xeron is on the National Priorities List or the Comprehensive Environmental Response Compensation and Liability Information System, and no such property is a Resource Conservation and Recovery Act "permitted facility." No such property is permitted by the state in which it is located to be used as a landfill or disposal site of any type.

(d) To the knowledge of Xeron, Section 3.13 of the Xeron Disclosure Schedule lists all tanks that have been owned, leased, operated or used by Xeron, or which are currently used by Xeron and are located on the Real Property, as such term is defined in Section 3.23.

(e) For purposes of this Agreement:

(i) "Environmental Claim" means any claim, action, cause of action, litigation, proceeding, order, decree, investigation or notice (written or oral) by any person or entity alleging potential liability or responsibility (including, without limitation, potential liability or responsibility for investigatory costs, cleanup costs, costs of compliance with laws, requirements, guidelines, or orders, governmental response costs, natural resources damages, property damages, personal injuries, or penalties) arising out of, based on or resulting from (a) the presence, or release into the environment, of any Materials of Environmental Concern at any location, whether or not owned or operated by Xeron or

(b) circumstances forming the basis of any violation, or alleged violation, of any Environmental Laws.

(ii) "Environmental Laws" means all Federal, state, local and foreign laws, regulations, ordinances, rules, guidelines, orders, directives, judgments and determinations relating in any way to pollution or protection of human health or the environment (including, without limitation, ambient air, surface water, ground water, land surface or subsurface strata), including, without limitation, laws and regulations relating to emissions, discharges, releases or threatened releases of Materials of Environmental Concern, or otherwise relating to the manufacture, processing, distribution, use, treatment, storage, disposal, transport or handling of Materials of Environmental Concern, as amended from time to time.

(iii) "Materials of Environmental Concern" means chemicals, pollutants, contaminants, hazardous materials, hazardous substances, hazardous wastes, toxic substances, petroleum and petroleum products, and any substance controlled or regulated by any Environmental Law.

SECTION 3.14 Change in Control. Except as set forth in Section 3.14 of the Xeron Disclosure Schedule, Xeron is not a party to any contract, agreement or understanding which contains a "change in control," "potential change in control" or similar provision. Except as set forth in Section 3.14 of the Xeron Disclosure Schedule, the consummation of the transactions contemplated by this Agreement will not (either alone or upon the occurrence of any additional acts or events) result in any payment (whether of severance pay or otherwise) becoming due from Xeron to any person.

#### SECTION 3.15 Intellectual Property.

(a) Except as set forth in Section 3.15(a) of the Xeron Disclosure Schedule, Xeron owns, or is licensed or otherwise has the full right to use, all copyrights, trademarks and service marks (including all applications and registrations therefor), trade names, computer software, patents (including applications therefor), and all other intellectual property that is necessary for the conduct of its business as heretofore conducted (collectively, the "Intellectual Property"). Xeron has not sold or conveyed to any third-party the right to use proprietary software developed by or for Xeron.

(b) Except as set forth in Section 3.15(b) of the Xeron Disclosure Schedule, there are no outstanding claims, judgments, settlements or proceedings against Xeron asserting the invalidity, abuse, misuse or unenforceability of any of the Intellectual Property and there are no threatened claims or proceedings relating to the validity of or enforceability of the Intellectual Property. There are no pending or threatened opposition or other administrative proceedings with respect to any Intellectual

Property which is the subject of a pending application that would prevent the registration in due course of such Intellectual Property.

SECTION 3.16 Contracts and Commitments. Except as set forth in Section 3.16 of the Xeron Disclosure Schedule:

(a) Xeron has no agreements, contracts, commitments, or restrictions that are material to its business, prospects, financial condition, working capital, assets, liabilities (absolute, accrued, contingent or otherwise) or operations;

(b) There are no purchase contracts or commitments under which Xeron is required to pay in excess of \$300,000, other than those incurred in the ordinary course of business;

(c) There are no outstanding sales contracts or commitments of Xeron that call for the payment to, or receipt by, Xeron of more than \$300,000, other than those incurred in the ordinary course of business;

(d) Xeron has no outstanding contracts with officers, directors or employees that are not cancelable by it on notice of not longer than thirty (30) days and without liability, penalty, or premium or any agreement or arrangement providing for the payment of any bonus or commissions based on sales or earnings;

(e) Xeron is not in default, nor aware of any facts or circumstances which could serve as the basis for any valid claim of default, under any material contract made or obligation owed by it;

(f) Xeron is not restricted by agreement from carrying on its business anywhere in the world;

(g) Xeron has no obligation with respect to borrowed money (except for a line of credit from Norwest Bank in the maximum amount of \$5,000,000), including debt obligations of its own or guarantees of or agreements to acquire any debt obligation of others;

(h) Xeron has no power of attorney outstanding or any obligations or liabilities (whether absolute, accrued, contingent, or otherwise), as guarantor, surety, co-signer, endorser, co-maker or indemnitor for the obligation of any person, corporation, partnership, joint venture, association, organization, or other entity; and

(i) None of the officers, directors or shareholders of Xeron has any interest in any property, real or personal, tangible or intangible, including without limitation Intellectual Property, that is used in the business of Xeron.

SECTION 3.17 Labor Relations. As of the date hereof, there is no strike or other labor dispute pending against Xeron. Xeron is not bound by or subject to (and none of its properties or assets is bound by or subject to) any written or oral, express or implied, contract, commitment or arrangement with any labor union, and no labor union has requested or sought to represent any of the employees, representatives or agents of Xeron, nor is Xeron aware of any labor organization activity involving its employees. Except as previously disclosed in writing to Chesapeake, no officer or employee of Xeron has any plans to terminate his employment with Xeron.

SECTION 3.18 Employee Benefit Plans. Except as disclosed in Section 3.18 of the Xeron Disclosure Schedule, Xeron has previously given to Chesapeake true and correct copies of its work rule manuals, rules, policies or other guidelines relating to employee compensation, retirement and severance and each employment or consulting contract to the extent they exist. Except as set forth in Section 3.18 of the Xeron Disclosure Schedule and except as previously disclosed to Chesapeake in writing, there are no other significant employee benefit plans, programs or arrangements, maintained or contributed to by Xeron.

SECTION 3.19 Personnel. Xeron has furnished to Chesapeake a list of the names and current salaries of each officer and employee of Xeron as of the date of this Agreement. Section 3.19 of the Xeron Disclosure Schedule sets forth a complete and correct list of all written employment, compensation, severance, consulting or indemnification contracts between Xeron and its present or former employees, officers, directors and consultants to the extent Xeron has any continuing obligations thereunder. Xeron has made available to Chesapeake true and correct copies of all such agreements.

SECTION 3.20 Insurance. Section 3.20(a) of the Xeron Disclosure Schedule contains an accurate and complete list of all policies of fire, liability, workmen's compensation and other forms of insurance owned or held by Xeron, except with respect to the policies as disclosed in Section 3.12 of the Xeron Disclosure Schedule. In the reasonable judgment of the Sellers, such policies are in adequate amounts and cover risks customarily insured against by businesses of the type operated by Xeron. Except as set forth in Section 3.20(a) of the Xeron Disclosure Schedule, all such policies are in full force and effect, all premiums with respect thereto covering all periods up to and including the Effective Time will have been paid, and no notice of cancellation of termination has been received with respect to any such policy. Except as set forth in Section 3.20(a) of the Xeron Disclosure Schedule, such policies will remain in full force and effect through the respective dates set forth in Section 3.20(a) of the Xeron Disclosure Schedule without the payment of additional premiums, and will not be materially affected by, or terminate or lapse by reason of, the transactions contemplated by this Agreement. All of such policies have been issued by reputable insurance companies actively engaged in the insurance business. All known claims, if any, made against Xeron that are covered by insurance have been disclosed to and accepted by the appropriate insurance companies and, to the knowledge of Xeron, are being defended by



such appropriate insurance companies and are described in Section 3.20(b) of the Xeron Disclosure Schedule, and, except as disclosed in Section 3.20(b) of the Xeron Disclosure Schedule, no claims have been denied coverage during the last three years.

SECTION 3.21 Receivables. All accounts and notes due and uncollected as reflected on the Financial Statements, and all accounts and notes due and uncollected arising subsequent to February 28, 1998 (i) have arisen in the ordinary course of business of Xeron, except as set forth in Section 3.21 of the Xeron Disclosure Schedule, and (ii) represent valid obligations due to Xeron enforceable in accordance with their terms, net of applicable reserves. Xeron has previously made available to Chesapeake lists of the aging and amounts of all accounts and notes due and uncollected at February 28, 1998. No reserve for bad debts is required as of February 28, 1998.

SECTION 3.22 Related Party Contracts. Except as set forth in Section 3.22 of the Xeron Disclosure Schedule, Xeron has no agreements, arrangements or commitments with related parties (including shareholders, directors and officers), other than the related-party agreements described in Sections 3.16(d) and 3.16(i) of the Xeron Disclosure Schedule. Except as set forth in Section 3.22 of the Xeron Disclosure Schedule, each of the related-party agreements was entered into between Xeron and the party thereto on an arm's length basis on terms no less favorable to Xeron than it could obtain from an unrelated third party.

#### SECTION 3.23 Real Property: Leased Premises.

(a) Section 3.23(a) of the Xeron Disclosure Schedule sets forth a true and complete list and description of all real property and land owned by Xeron and the buildings, improvements and structures located thereon, except for the Leased Premises (as defined below) (collectively, the "Real Property"). Each of the material improvements located upon the Real Property owned or used by Xeron (including, without limitation, all buildings, land and equipment leased by Xeron) is in reasonably good repair and operating condition.

(b) Xeron has good and valid title to the Real Property in fee simple and to the structures and fixtures attached or appurtenant to or used in connection with the Real Property, free and clear of all Liens, except (i) as set forth in Section 3.23(b) of the Xeron Disclosure Schedule, and (ii) Permitted Liens.

(c) Section 3.23(c) of the Xeron Disclosure Schedule sets forth a true and complete list of each lease of premises executed by or binding upon Xeron as lessee, sublessee, tenant or assignee (the "Leased Premises"). Except as set forth in Section 3.23(c) of the Xeron Disclosure Schedule, each such lease is in full force and effect without any default or breach thereof by Xeron or, to the knowledge of Xeron, by any other party thereto. True and complete copies of all leases listed on Schedule 3.23(c)

of the Xeron Disclosure Schedule (including all amendments, addenda, waivers and all other binding documents relating thereto) have been made available to Chesapeake.

(d) Except as set forth in Section 3.23(d) of the Xeron Disclosure Schedule, Xeron has not received any notice of or writing referring to any requirements by any insurance company that has issued a policy covering any part of any Real Property or Leased Premises or by any board of fire underwriters or other body exercising similar functions, requiring any repairs or work to be done on any part of any Real Property or Leased Premises.

SECTION 3.24 Absence of Certain Payments. Neither Xeron nor any of its affiliates or any of their respective officers, directors, employees or agents or other people acting on behalf of Xeron have (i) engaged in any activity prohibited by the United States Foreign Corrupt Practices Act of 1977 or any other similar law, regulation, decree, directive or order of any other country and (ii) without limiting the generality of the preceding clause (i), used any corporate or other funds for unlawful contributions, payments, gifts or entertainment, or made any unlawful expenditures relating to political activity to government officials or others. None of Xeron or any of its affiliates or any of their respective directors, officers, employees or agents of other persons acting on behalf of Xeron, has accepted or received any unlawful contributions, payments, gifts or expenditures.

SECTION 3.25 Disclosure. No representation or warranty by Xeron or the Sellers in this Agreement and no statement in any document, schedule or certificate furnished or to be furnished by the Sellers to Chesapeake or any of its representatives pursuant to the provisions hereof or in connection with the transactions contemplated hereby, contains any untrue statement of material fact or omits or will omit to state any material fact necessary in order to make the statements herein or therein, in light of the circumstance under which they were made, not misleading.

#### SECTION 3.26 PUHCA.

(a) Xeron is not a "public-utility company," as that term is defined in Section 2(a)(5) of the Public Utility Holding Company Act of 1935, and the rules and regulations thereunder (the "1935 Act").

(b) Upon consummation of the Merger, none of the Shareholders, individually or in the aggregate, shall constitute a "holding company" with respect to Chesapeake, as that term is defined in Section 2(a)(7) of the 1935 Act.

(c) None of the Sellers, individually or in the aggregate, directly or indirectly owns, controls or holds with power to vote five percent or more of the outstanding voting securities of a public-utility company, as that term is defined in Section 2(a)(5) of the 1935 Act.

SECTION 3.27 Pooling Matters. The representations, warranties and covenants of Xeron set forth in the form of letter from Xeron to Coopers & Lybrand, attached hereto as Annex A-1, are true and correct in all material respects (except as such matters may be subject to the control of Chesapeake or its affiliates).

SECTION 3.28 Year 2000. Except as set forth in Section 3.28 of the Xeron Disclosure Schedule, Xeron does not rely on any computer or information systems or equipment that will not operate or perform properly using dates for January 1, 2000 and beyond.

SECTION 3.29 Knowledge. The phrase "to the knowledge of Xeron" means to the knowledge of Xeron or any of its officers.

#### ARTICLE IV REPRESENTATIONS AND WARRANTIES OF CHESAPEAKE

Chesapeake represents and warrants to the Sellers as follows:

SECTION 4.1 Corporate Organization. Each of Chesapeake and CPK-Sub-C is a corporation duly organized, validly existing and in good standing under the laws of the jurisdiction of its incorporation and has all requisite corporate power and authority to own, lease and operate its properties and to carry on its business as now being conducted. The Certificate of Incorporation and By-laws of Chesapeake, as currently in effect, are filed as exhibits to Chesapeake's Annual Report on Form 10-K. Chesapeake has heretofore delivered to the Sellers accurate and complete copies of the Certificate of Incorporation and By-laws, as currently in effect, of Chesapeake.

SECTION 4.2 Capitalization. As of the date of this Agreement, the authorized capital stock of Chesapeake consists of 12,000,000 shares of Chesapeake Common Stock and 2,000,000 shares of preferred stock, of which 4,577,778 shares of Chesapeake Common Stock are issued and outstanding. All of such issued and outstanding shares of Chesapeake Common Stock are validly issued, fully paid and nonassessable and free of preemptive rights. As of the date of this Agreement, (i) 163,637 shares of Chesapeake Common Stock were issuable upon exercise of warrants or stock options; 26,700 shares of Chesapeake Common Stock were issuable in accordance with Chesapeake's Long Term Incentive Awards Plan; and 173,771 shares of Chesapeake Common Stock were reserved for issuance under such plans and (ii) there are \$3,852,000 face amount convertible debt securities outstanding that are convertible into 226,455 shares of Chesapeake Common Stock. Except as set forth above and in the Chesapeake financial statements and other public filings, or as may be required in connection with Chesapeake's ongoing acquisition activities, there are not any shares of capital stock (or securities substantially equivalent to capital stock) of Chesapeake issued or outstanding or any subscriptions, options, warrants, calls, rights, convertible securities or other

agreements or commitments of any character obliging Chesapeake to issue, transfer or sell any of its securities.

SECTION 4.3 Authority Relative to this Agreement. Each of Chesapeake and CPK-Sub-C has full corporate power and authority to execute and deliver this Agreement and to consummate the transactions contemplated hereby. The execution and delivery of this Agreement and the consummation of the transactions contemplated hereby have been duly and validly authorized and approved by the Boards of Directors of Chesapeake and CPK-Sub-C and by Chesapeake as the sole shareholder of CPK-Sub-C and no other corporate proceedings on the part of Chesapeake or CPK-Sub-C are necessary to authorize this Agreement or to consummate the transactions so contemplated. This Agreement has been duly and validly executed and delivered by each of Chesapeake and CPK-Sub-C and constitutes a valid and binding agreement of each of Chesapeake and CPK-Sub-C, enforceable against each of Chesapeake and CPK-Sub-C in accordance with its terms.

SECTION 4.4 Consents and Approvals; No Violations. Except for the filing and recordation of the Articles of Merger, as required by the MGCL, and the Certificate of Merger, as required by the DGCL, the filing with the Delaware Public Utilities Commission, and as set forth in Section 4.4 of the disclosure schedule to be delivered to the Sellers prior to the date of this Agreement (the "Chesapeake Disclosure Schedule"), no filing with or notification to, and no permit, authorization, consent, waiver or approval of, any Governmental Entity, is necessary for the consummation by Chesapeake of the transactions contemplated by this Agreement. Except as set forth in Section 4.4 of the Chesapeake Disclosure Schedule, neither the execution and delivery of this Agreement by Chesapeake or CPK-Sub-C nor the consummation by Chesapeake and CPK-Sub-C of the transactions contemplated hereby nor compliance by Chesapeake or CPK-Sub-C with any of the provisions hereof will (i) conflict with or result in any breach of any provision of the Certificate of Incorporation or By-laws of Chesapeake or any of its subsidiaries, (ii) result in a violation or breach of, or constitute (with or without due notice or lapse of time or both) a default (or give rise to any right of termination, cancellation or acceleration or result in the creation of any Lien) under, any of the terms, conditions or provisions of any note, bond, mortgage, indenture, license, contract, agreement or other instrument or obligation to which Chesapeake or any of its subsidiaries is a party or by which any of them or any of their respective properties or assets may be bound or (iii) violate any order, writ, injunction, decree, statute, treaty, rule or regulation applicable to Chesapeake, any of its subsidiaries or any of their properties or assets.

SECTION 4.5 SEC Reports. Chesapeake has filed on a timely basis all required forms, reports and documents with the Securities and Exchange Commission ("SEC") since January 1, 1994 (collectively, the "Chesapeake SEC Reports"), each of which has complied in all material respects with all applicable requirements of the Securities Act of 1933 (the "Securities Act"), and the Securities Exchange Act of 1934

(the "Exchange Act"), and the rules and regulations of the SEC, as each was in effect on the dates so filed. Chesapeake has heretofore delivered to Xeron and the Sellers in the form filed with the SEC, its (i) Annual Reports on Form 10-K for each of the last three fiscal years and (ii) all definitive proxy statements relating to Chesapeake meetings of shareholders (whether annual or special) held since January 1, 1994. The audited consolidated financial statements and unaudited consolidated interim financial statements of Chesapeake included in the Chesapeake SEC Reports are true, correct and complete in all material respects; fairly present, in conformity with generally accepted accounting principles applied on a consistent basis (except as may be indicated in the notes thereto), the consolidated financial position of Chesapeake and its consolidated subsidiaries as of the dates thereof and their consolidated results of operations and changes in financial position and changes in stockholders equity and cash flows for the periods then ended (subject to normal year-end and audit adjustments in the case of any unaudited interim financial statements).

SECTION 4.6 CPK-Sub-C. CPK-Sub-C has not conducted any operations or incurred any liabilities or obligations other than arising under or in connection with its formation and the transactions contemplated by this Agreement.

SECTION 4.7 Chesapeake Shares. All of the shares of Chesapeake Common Stock to be issued in connection with the Merger will, at the time of such issuance, be validly issued, fully paid and nonassessable and free of preemptive rights and free of any adverse liens, claims, charges or encumbrances.

SECTION 4.8 Disclosure. No representation or warranty by Chesapeake in this Agreement and no statement contained in any document (including without limitation, the Chesapeake SEC Reports), schedule or certificate furnished or to be furnished by Chesapeake to the Sellers or any of their representatives pursuant to the provisions hereof or in connection with the transactions contemplated hereby, contains any untrue statement of material fact or omits or will omit to state any material fact necessary in order to make the statements herein or therein, in light of the circumstances under which they were made, not misleading.

SECTION 4.9 Pooling Matters. The representations, warranties and covenants of Chesapeake set forth in the form of letter from Chesapeake to Coopers & Lybrand attached to this Agreement as Annex A-2 are true and correct in all material respects (except as such matters may be subject to the control of Xeron or its affiliates).

SECTION 4.10 Absence of Certain Changes. Except as and to the extent set forth in Section 4.10 of the Chesapeake Disclosure Schedule, since December 31, 1997 Chesapeake has not:

(a) suffered any material Adverse Change; "Material Adverse Change" means (i) any material change in the nature of Chesapeake's business, assets, financial

condition, results of operations, or prospects, (ii) the loss of a contract which would have a material adverse effect on Chesapeake, and (iii) any change that creates a material limitation on the ability of Chesapeake to conduct its business as heretofore conducted;

(b) agreed or planned, whether in writing or otherwise, to take any action described in this Section.

SECTION 4.11 Audited Financial Statements. Chesapeake shall have furnished to Xeron prior to the date of this Agreement copies of Chesapeake's Form 10-K for the fiscal years 1995, 1996 and 1997 filed with the Securities and Exchange Commission.

SECTION 4.12 No Undisclosed Liabilities. Except as and to the extent provided in the Chesapeake SEC Reports or Section 4.12 of the Chesapeake Disclosure Schedule, Chesapeake does not have any material liabilities (whether contingent or absolute, direct or indirect, known or unknown to Chesapeake or matured or unmatured) not fully reflected or fully reserved against in the Chesapeake financial statements.

SECTION 4.13 No Default. Except as set forth in Section 4.13 of the Chesapeake Disclosure Schedule, Chesapeake is not in default or violation (and no event has occurred that with notice or the lapse of time or both would constitute a default or violation) of any material term, condition or provision of (i) its Certificate of Incorporation or its By-Laws, (ii) any note, bond, mortgage, indenture, license, contract, agreement or other instrument or obligation to which Chesapeake is a party or by which it or any of its properties or assets are bound, or (iii) any order, writ, injunction, decree, statute, rule or regulation applicable to Chesapeake or any of its properties or assets, unless such default would not have a material adverse effect on Chesapeake.

SECTION 4.14 Litigation. Except as set forth in Chesapeake's SEC Reports or in Section 4.14 of the Chesapeake Disclosure Schedule, there is no material action, suit, proceeding, arbitration, or investigation pending or to the best of Chesapeake's knowledge, threatened by or before any Governmental Entity involving Chesapeake or any of its properties or assets. Except as set forth in Chesapeake's SEC Reports or in Section 4.14 of the Chesapeake Disclosure Schedule, neither Chesapeake nor any of its material properties or assets is subject to any order, writ, judgment, injunction, decree, determination or award.

SECTION 4.15 Compliance with Applicable Law. Except as set forth in Section 4.15 of the Chesapeake Disclosure Schedule, the business of Chesapeake has not been conducted in violation of any applicable law, ordinance, rule, regulation, decree or order of any Governmental Entity, unless such violation would not result in a material adverse effect on Chesapeake. Chesapeake holds all permits, licenses, variances, exemptions, orders and approvals of all Governmental Entities necessary for the lawful conduct of its businesses (the "Chesapeake Permits") and is in compliance with the terms

of the Chesapeake Permits, unless the failure to obtain any Chesapeake Permits or be in compliance therewith will not result in a material adverse effect on Chesapeake. Except as set forth in Section 4.15 of the Chesapeake Disclosure Schedule, Chesapeake has not received any notification of any asserted present or past failure by Chesapeake to comply with such laws, rules or regulations or such Chesapeake Permits which have not been previously cured, and there is, to the knowledge of Chesapeake, no pending audit, investigation or other review by any Governmental Entity to determine the existence of any violation of such laws, rules or regulations or such Chesapeake Permits.

#### SECTION 4.16 Taxes.

(a) To the knowledge of Chesapeake, Chesapeake has duly filed with the appropriate governmental authorities all Tax Returns (as defined in Section 4.16(c)) required to be filed by it for all periods ending on or prior to the date hereof, and such Tax Returns are true, correct and complete in all material respects, and (ii) duly paid in full all Taxes (as defined in Section 4.16(b)) due in connection with or with respect to the filing of such Tax Returns and has paid all other Taxes as are due, except such as are being contested in good faith by appropriate proceeding and with respect to which Chesapeake is maintaining reserves adequate for their payment. Neither the Internal Revenue Service (the "IRS") nor any other governmental entity or taxing authority or agency is now asserting, either through audits, administrative proceedings, court proceedings or otherwise, or threatening to assert against any deficiency or claim for additional Taxes. Chesapeake has not been granted any waiver of any statute of limitations with respect to, or any extension of a period for the assessment of, any Tax that is currently in effect. There are no tax liens on any assets of Chesapeake. Chesapeake has not received a ruling or entered into an agreement with the IRS, or any other governmental entity or taxing authority or agency that would have a material adverse effect on Chesapeake after the Effective Time. The accruals and reserve for Taxes reflected in Chesapeake's most recent balance sheet included in the Chesapeake SEC Reports are adequate to cover all Taxes accruable through the date thereof (including Taxes being contested) in accordance with generally accepted accounting principles. Except for Chesapeake and its subsidiaries' intercompany tax allocation agreements, no agreements relating to allocating or sharing of Taxes exist among Chesapeake and its subsidiaries and no tax indemnities given by Chesapeake in connection with a sale of stock or assets remain in effect.

(b) For purposes of this Section, the term "Taxes" shall mean all taxes, including, without limitation, income, gross receipts, excise, property, sales, withholding, social security, occupation, use, service, service use, license, payroll, franchise, transfer and recording taxes, fees and charges, windfall profits, severance, customs, import, export, employment or similar taxes, charges, fees, levies or other assessments imposed by the United States, or any state, local or foreign government or subdivision or agency thereof, whether computed on a separate, consolidated, unitary, combined or any other basis, and such terms shall include any interest, fines, penalties, or

additional amounts and any interest in respect to any addition, fines, or penalties attributable or imposed or with respect to any such taxes, charges, fees, levies or other assessments.

(c) For purposes of this Section, the term "Tax Return" shall mean any return, report or other document or information required to be supplied to a taxing authority in connection with Taxes.

SECTION 4.17 Labor Relations. As of the date hereof, there is no material strike or other labor dispute pending against Chesapeake. Except as previously disclosed in writing to Xeron, no officer of Chesapeake has notified Chesapeake of any plans to terminate his employment with Chesapeake.

SECTION 4.18 Related Party Contracts. Except as set forth in Section 4.18 of the Chesapeake Disclosure Schedule or the Chesapeake SEC Reports, Chesapeake has no agreements, arrangements or commitments with related parties (including shareholders, directors and officers), other than the related-party agreements described in Section 4.21 of the Chesapeake Disclosure Schedule. Except as set forth in Section 4.18 of the Chesapeake Disclosure Schedule, each of the related-party agreements was entered into between Chesapeake and the party thereto on an arm's length basis on terms less favorable to Chesapeake than it could obtain from an unrelated third party.

SECTION 4.19 Absence of Certain Payments. Neither Chesapeake nor any of its affiliates or any of their respective officers, directors, employees or agents or other people acting on behalf of Chesapeake have (i) engaged in any activity prohibited by the United States Foreign Corrupt Practices Act of 1977 or any other similar law, regulation, decree, directive or order of any other country and (ii) without limiting the generality of the preceding clause (i), used any corporate or other funds for unlawful contributions, payments, gifts or entertainment, or made any unlawful expenditures relating to political activity to government officials or others. None of Chesapeake or any of its affiliates or any of their respective directors, officers, employees or agents or other persons acting on behalf of Chesapeake, has accepted or received any unlawful contributions, payments, gifts or expenditures.

SECTION 4.20 Environmental Matters. Except as set forth in the Chesapeake Disclosure Schedule or in the Chesapeake SEC Reports, to Chesapeake's knowledge Chesapeake has no material liabilities relating to environmental matters.

SECTION 4.21 Contracts and Commitments. Except as set forth in Section 4.21 of the Chesapeake Disclosure Schedule:

(a) Chesapeake is not restricted by agreement from carrying on its business anywhere in the world;



(b) Chesapeake has no obligation with respect to borrowed money, including debt obligations of its own or guarantees of or agreements to acquire any debt obligation of others not reflected on the Chesapeake financial statements; and

(c) Chesapeake has no power of attorney outstanding or any obligations or liabilities (whether absolute, accrued, contingent, or otherwise), as guarantor, surety, co-signor, endorser, co-maker or indemnitor for the obligation of any person, corporation, partnership, joint venture, association, organization, or other entity not reflected in the Chesapeake financial statements.

SECTION 4.22 Knowledge. The phrase "to the knowledge of Chesapeake" means to the knowledge of Chesapeake or any of its officers.

## ARTICLE V COVENANTS OF XERON AND SELLERS

Each of the Sellers covenants and agrees as follows:

SECTION 5.1 Conduct of Business Pending the Merger. Except as otherwise specifically provided in this Agreement or as otherwise consented to in writing by Chesapeake, from the date of this Agreement to the Effective Time, Xeron will (and the Shareholders will cause Xeron to) conduct its operations only in the ordinary and usual course of business and consistent with past practices and will preserve intact its present business organization, take all reasonable efforts to keep available the services of its present officers, employees and consultants and preserve its present relationships with licensors, licensees, customers, suppliers, employees, labor organizations and others with whom it has a significant business relationship. Without limiting the generality of the foregoing, and except as otherwise specifically provided in this Agreement or as set forth in Section 5.1 of the Xeron Disclosure Schedule, Xeron will not directly or indirectly (and the Shareholders will cause Xeron not to), from the date of this Agreement to the Effective Time, without the prior written consent of Chesapeake:

(a) adopt any amendment to or otherwise change its Articles of Incorporation or By-laws or other organizational documents;

(b) authorize for issuance, sale, pledge, disposition or encumbrance, or issue, sell, pledge, dispose of or encumber (whether through the issuance or granting of options, warrants, commitments, subscriptions, rights to purchase, convertible securities or otherwise), any capital stock of any class or any other securities of, or any other ownership interest in, Xeron or amend any of the terms of any such securities or agreements outstanding on the date hereof;

(c) reclassify, combine, split or subdivide any shares of its capital stock, declare, set aside or pay any dividend or other distribution (whether in cash, securities or property or any combination thereof) in respect of any class or series of its capital stock;

(d) redeem, purchase or otherwise acquire, or propose or offer to redeem, purchase or otherwise acquire, any outstanding shares of Xeron Common Stock or other securities of Xeron;

(e) organize any new subsidiary, acquire any capital stock or equity securities of any corporation or acquire any equity or ownership interest (financial or otherwise) in any business;

(f) (i) incur, assume or prepay any material liability, including without limitation, any indebtedness for borrowed money except in the ordinary course of business and consistent with past practice; (ii) assume, guarantee, endorse or otherwise become liable or responsible (whether directly, contingently or otherwise) for obligations of any third party, (iii) make any loans, advances or capital contributions to, or investments in, any third party, (iv) mortgage or pledge any of its material properties or assets, tangible or intangible, or create any material Lien thereupon other than Permitted Liens, or (v) authorize any new capital expenditures which, individually or in the aggregate, are in excess of \$25,000;

(g) license (except to end users in the ordinary course of business, consistent with past practice and pursuant to a written license agreement) or otherwise transfer, dispose of, permit to lapse or otherwise fail to preserve any of Xeron's Intellectual Property, or dispose of or disclose to any person any trade secret, formula, process or know-how not theretofore a matter of public knowledge;

(h) enter into any agreement, contract, commitment or transaction other than in the ordinary course of business, consistent with past practices or that would be required to be included in Section 3.16 of the Xeron Disclosure Schedule if entered into prior to the date of this Agreement;

(i) increase the compensation payable or to become payable to its officers or employees, except for increases in salary or wages of non-officer employees of Xeron in accordance with past practices, or grant any severance or termination pay or stock options to, or enter into any employment or severance agreement with, any director, officer, or other employee of Xeron, or establish, adopt, enter into, or amend any collective bargaining, bonus, profit sharing, thrift, compensation, stock option, restricted stock, pension, retirement, deferred compensation, employment, termination, severance, or other plan, agreement, trust, fund, policy, or arrangement for the benefit of any current or former directors, officers, or employees;

(j) cancel any debts or waive, release or relinquish any material contract rights or other rights of substantial value other than in the ordinary course of business, consistent with past practices;

(k) authorize, recommend, propose or enter into or announce an intention to authorize, recommend, propose or enter into an agreement in principle or a definitive agreement with respect to any merger, consolidation, liquidation, dissolution, or business combination, any acquisition of a material amount of property or assets or securities, or any disposition of a material amount of property or assets or securities;

(l) make any change with respect to accounting policies or procedures in effect as of November 30, 1997 except as may be required by generally accepted accounting principles;

(m) pay, discharge or satisfy any claims, liabilities or obligations (absolute, accrued, asserted or unasserted, contingent or otherwise) other than the payment, discharge or satisfaction in the ordinary course of business, consistent with past practices, of liabilities reflected or reserved against in the Financial Statements or incurred in the ordinary course of business consistent with past practices since the date hereof; or

(n) commit or agree (in writing or otherwise) to take any of the foregoing actions or any action which would make any representation or warranty in this Agreement untrue or incorrect, either as of the date hereof or of the Effective Time, as if made as of such time.

SECTION 5.2 Tax Status. Shareholders and Xeron shall refrain from taking any action that would impair Xeron from being deemed a "C" corporation for federal income tax purposes at the Effective Time.

SECTION 5.3 Access to Information. Upon reasonable notice, Xeron shall afford to the officers, employees, accountants, counsel, environmental consultants and other representatives of Chesapeake, reasonable access, during normal business hours during the period prior to the Effective Time, to all its properties, books, contracts, commitments and records and, during such period, Xeron shall furnish promptly to Chesapeake all information concerning its business, properties and personnel as Chesapeake may reasonably request.

SECTION 5.4 No Solicitation. Sellers will not and will cause their affiliates not to, and will cause their respective officers, directors, employees and agents retained by Sellers or any of their affiliates not to, initiate or solicit, directly or indirectly, any inquiries or the making of any proposal with respect to, or engage in negotiations concerning, provide any information or data to, or have any discussions with, any Third Party (as hereinafter defined) relating to, any public offering of securities of, or acquisition, business combination or purchase of all or any significant portion of the

properties or assets of, or any equity interest in, Xeron (an "Acquisition Proposal"). Sellers and Xeron will immediately cease and cause to be terminated any existing activities, discussions or negotiations with any Third Party conducted heretofore with respect to any Acquisition Proposal. Sellers and Xeron shall immediately notify Chesapeake if, subsequent to the date hereof, any such negotiations, provision of information or data or discussions are entered into or made or any such inquiries are received in respect thereof, and shall provide details with respect thereto, including the identity of such Third Party and the price and terms of any Acquisition Proposal. As used in this Agreement, the term "Third Party" means any "person" or "group", as such terms are defined in Section 13(d) of the Exchange Act, other than Chesapeake or any affiliate of Chesapeake.

SECTION 5.5 Further Information. As soon as practicable after such information becomes available, and in any event not later than thirty (30) days after the end of each fiscal month, Xeron shall provide to Chesapeake an unaudited consolidated balance sheet as of the end of such month and the related consolidated statements of results of operations and statements of cash flows for such period.

SECTION 5.6 Affiliates. Prior to the execution of this Agreement, Xeron shall deliver to Chesapeake a letter identifying all persons who may be deemed, as of the date of this Agreement, "affiliates" of Xeron for purposes of Rule 145 under the Securities Act. Xeron shall cause each person named in such letter to deliver a written agreement substantially in the form attached hereto as Exhibit 5.6.

SECTION 5.7 PUHCA. Each Shareholder covenants that he will take no action at any time that will cause the Shareholders to be deemed a "holding company" with respect to Chesapeake as that term is defined in Section 2(a)(7) of the 1935 Act. With respect to Chesapeake, each Shareholder will act as an individual and on his own behalf, and not in concert with or as a group with any other Shareholder or any other person. The covenants contained in this Section 5.7 will continue with respect to a Shareholder as long as the Shareholders remain in the aggregate owners of ten percent or more of the outstanding voting securities of Chesapeake. This Section 5.7 and any claims for breach hereof are not subject to the limitations set forth in Article IX.

## ARTICLE VI COVENANTS OF CHESAPEAKE

SECTION 6.1 Conduct of Business Pending the Merger. Except as otherwise specifically provided in this Agreement, as disclosed in its SEC filings or press releases, in connection with its ongoing acquisition program, in connection with Chesapeake's compensation program for directors or as otherwise consented to in writing by Xeron, from the date of this Agreement to the Effective Time, Chesapeake will conduct its operations in the ordinary and usual course of business and consistent with

past practices, will preserve intact its present business organization, take all reasonable efforts to keep available the services of its present officers, employees and consultants and preserve its present relationships with licensors, licensees, customers, suppliers, employees, labor organizations and others with whom it has a significant business relationship, and will not

(a) adopt any amendment to or otherwise change its Certificate of Incorporation of By-laws or other organizational documents;

(b) authorize for issuance, sale, pledge, disposition or encumbrance, or issue, sell, pledge, dispose of or encumber (whether through the issuance or granting of options, warrants, commitments, subscriptions, rights to purchase, convertible securities or otherwise), any capital stock of any class or any other securities of, or any other ownership interest in, Chesapeake or amend any of the terms of any such securities or agreements outstanding on the date hereof; or

(c) redeem, purchase or otherwise acquire, or propose or offer to redeem, purchase or otherwise acquire, any outstanding shares of Chesapeake Common Stock or securities of Chesapeake.

## ARTICLE VII MUTUAL COVENANTS

SECTION 7.1 Reasonable Efforts. Subject to the terms and conditions of this Agreement, each of the parties hereto agrees to use all reasonable efforts to take, or cause to be taken, all actions, and to do, or cause to be done, all things necessary, proper or advisable to assure that all conditions to Closing set forth in Article VIII of this Agreement are satisfied as expeditiously as possible including, without limitation, the preparation and filing of all forms, registrations and notices required to be filed to consummate the transactions contemplated hereby and the taking of such actions as are necessary to obtain any requisite approvals, consents, orders, exemptions or waivers by any public or private third party. Each party shall promptly consult with the other with respect to, provide any necessary information with respect to and provide the other (or its counsel) copies of, all filings made by such party with any Governmental Entity in connection with this Agreement and the transactions contemplated hereby.

SECTION 7.2 Brokers or Finders. Each of the Sellers and Chesapeake represents, as to itself, its subsidiaries and its affiliates, that no agent, broker, investment banker, financial advisor or other firm or person is or will be entitled to any broker's or finder's fee or any other commission or similar fee in connection with any of the transactions contemplated by this Agreement. The Sellers and Chesapeake agree to indemnify and hold the other harmless from and against any such claims, liabilities or

obligations with respect to any broker's or finder's fees, commissions or expenses determined to be owed by them or it.

SECTION 7.3 Notification of Certain Matters. The Sellers shall give prompt notice to Chesapeake and CPK-Sub-C, and Chesapeake and CPK-Sub-C shall give prompt notice to the Sellers, of the occurrence (or non-occurrence) of any event of which Sellers, Chesapeake or CPK-Sub-C has knowledge, respectively, the occurrence (or non-occurrence) of which would be likely to cause any representation or warranty contained in this Agreement to be untrue or inaccurate in any respect (including as of the Effective Time) and of any failure of either party to comply with or satisfy any covenant, condition or agreement to be complied with or satisfied by it hereunder; provided, however, that delivery of any notice pursuant to this Section 7.3 shall not limit or otherwise affect the remedies available to either party hereunder.

SECTION 7.4 Fees and Expenses. Whether or not the Merger is consummated, all costs and expenses incurred in connection with this Agreement and the transactions contemplated hereby shall be paid by the party incurring such expenses in the normal course of business.

SECTION 7.5 Further Assurances. After the Closing, Chesapeake and the Sellers shall from time to time, at the request of the other party and without further cost or expense to the requesting party, execute and deliver such other instruments of conveyance and transfer and take such other actions as such other party may reasonably request in order more effectively to carry out this Agreement.

## ARTICLE VIII CONDITIONS

SECTION 8.1 Conditions to Each Party's Obligation to Effect the Merger. The respective obligations of each party to effect the Merger shall be subject to the satisfaction at or prior to the Effective Time of the following conditions: no statute, rule, regulation, executive order, decree or injunction shall have been enacted, entered, promulgated or enforced by any United States court or Governmental Entity of competent jurisdiction that prohibits the consummation of the Merger and shall be in effect.

SECTION 8.2 Conditions of Obligations of the Sellers. The obligation of the Sellers to effect the Merger is further subject to the satisfaction at or prior to the Effective Time of the following conditions, unless waived by Sellers:

(a) The representations and warranties of Chesapeake set forth in this Agreement shall be true and correct in all respects as of the date of this Agreement and as of the Effective Time (except that representations and warranties that are made as of a specified date shall be true and correct in all respects as of such specified date).

(b) Chesapeake shall have performed and complied, in all respects, with all obligations and covenants required to be performed or complied with by it under this Agreement at or prior to the Effective Time.

(c) Chesapeake shall have obtained all consents, approvals, authorizations and permits required from third parties and any Governmental Entity (applicable to Chesapeake and its subsidiaries) necessary for the consummation by Chesapeake of the transactions contemplated by this Agreement.

(d) Sellers shall have received from Chesapeake an officer's certificate substantially in the form of Exhibit 8.2(d) attached hereto.

(e) The Stock Consideration to be issued pursuant to this Agreement shall have been listed on the NYSE.

(f) Chesapeake shall have executed and delivered the letter to Coopers & Lybrand in the form of Annex A-2 attached hereto.

(g) Chesapeake shall have delivered executed Employment Agreements for J. Phillip Keeter and Earnest A. Allen, Jr. in the form of Annexes B-1 and B-2 hereto, and Chesapeake shall have delivered executed employment agreements for Patrick Armand, Carl E. Mendenhall, David Snyder and Marilyn Johnson satisfactory to the parties thereto.

(h) Chesapeake shall have caused the Shareholders to be released from their personal guaranties of the indebtedness of Xeron listed on Schedule 8.2(h) hereto.

(i) From the date of this Agreement through the Effective Time, Chesapeake shall not have suffered a Material Adverse Change.

SECTION 8.3 Conditions of Obligations of Chesapeake. The obligation of Chesapeake to effect the Merger is further subject to the satisfaction at or prior to the Effective Time of the following conditions, unless waived by Chesapeake:

(a) The representations and warranties of Sellers set forth in this Agreement shall be true and correct in all respects as of the date of this Agreement and as of the Effective Time (except that representations and warranties that are made as of a specified date shall be true and correct in all respects as of such specified date).

(b) Sellers shall have performed and complied with, in all respects, all obligations and covenants required to be performed or complied with by it under this Agreement at or prior to the Effective Time.

(c) Sellers shall have obtained all consents, approvals, authorizations and permits required from third parties and any Governmental Entity (applicable to Xeron or any of its shareholders) necessary for the consummation by Sellers of the transactions contemplated by this Agreement.

(d) The Stock Transfer Restriction Agreement dated September 28, 1987, as amended or supplemented, shall have been terminated in writing in accordance with the terms thereof.

(e) Chesapeake shall have received from Xeron an officer's certificate substantially in the form of Exhibit 8.3(e) attached hereto.

(f) Chesapeake shall have received from each Shareholder a certificate substantially in the form of Exhibit 8.3(f) attached hereto.

(g) Chesapeake shall have received from Lowrey & Millikin, L.L.P., counsel to the Sellers, an opinion substantially in the form of Exhibit 8.3(g) attached hereto.

(h) Chesapeake shall have received from each of the Shareholders, investment representation letters substantially in the form of Exhibit 8.3(h) attached hereto.

(i) From the date of this Agreement through the Effective Time, Xeron shall not have suffered a Material Adverse Change.

(j) All necessary approvals from the Delaware Public Service Commission regarding the issuance of the shares of Chesapeake Common Stock shall have been granted by final order.

(k) All rights of first refusal pursuant to the Articles of Incorporation of Xeron or otherwise held by any Shareholder shall have been waived or terminated in writing.

(l) All waiting periods shall have expired and/or all necessary approvals, authorizations, consents, or waivers have been received for the consummation of the transaction pursuant to the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended.

(m) Xeron shall have executed and delivered the letter to Coopers & Lybrand in the form of Annex A-1 attached hereto.

(n) Coopers & Lybrand shall have delivered to Chesapeake an opinion letter confirming that the merger may be accounted for as a pooling of interests



under the requirements of Accounting Principles Board Opinion (APB) No. 16, Business Combinations, and the related published interpretations of the American Institute of Certified Public Accountants and the Financial Accounting Standards Board, and the published rules and regulations of the Securities and Exchange Commission.

(o) The Sellers shall have delivered executed Employment Agreements for J. Phillip Keeter and Earnest A. Allen, Jr. in the form of Annexes B-1 and B-2 hereto, and the Sellers shall have delivered executed employment agreements for Patrick Armand, Carl E. Mendenhall, David Snyder and Marilyn Johnson satisfactory to Chesapeake.

(p) The Sellers shall have provided Chesapeake with such representations and evidence as Chesapeake's counsel advises are necessary or appropriate to ensure compliance with applicable federal and state securities laws.

## ARTICLE IX SURVIVAL AND INDEMNIFICATION

SECTION 9.1 Survival of Representations and Warranties. All statements, certifications, representations, and warranties provided for herein shall survive beyond the Effective Time and continue in full force and effect at all times as provided in this Article IX (and shall not in any manner be affected or impaired by the consummation of the transactions contemplated by this Agreement or by any investigation made by or on behalf of any party) until the termination of this Agreement pursuant to Section 10.1 or the period for identifying a claim of breach or default pursuant to the limitations prescribed under Section 9.2(d)(i) and (ii) shall have expired.

### SECTION 9.2 Indemnification.

(a) Indemnity by Chesapeake. Chesapeake shall indemnify and defend and hold each Shareholder harmless from and against all claims, liabilities, damages, losses and expenses (including reasonable attorneys' fees) of every kind and character (exclusive however of any amounts covered by Section 9.2(b)) resulting from or relating to or arising out of the inaccuracy, nonfulfillment, nonperformance or breach of any representation, warranty, covenant, agreement or obligation of Chesapeake contained herein.

(b) Indemnity by the Shareholders. Each Shareholder shall indemnify and defend and hold Chesapeake and its affiliates harmless from and against all claims, liabilities, damages, losses and expenses (including reasonable attorneys' fees) of every kind and character (exclusive however of any amounts covered by Section 9.2(a)) incurred by Chesapeake and its affiliates and resulting from or relating to or arising out of the inaccuracy, nonfulfillment, nonperformance or breach of any

representation, warranty, covenant, agreement or obligation of the Sellers contained herein.

(c) Third Party Claims. If a claim for which indemnification may be sought under this Section 9.2 is asserted by third parties (including any environmentally related remedial or clean up work) (the "Third Party Claims"), such Third Party Claim will be subject to the following terms and conditions: (i) upon receipt of written notice of any Third Party Claim asserted against, imposed upon or incurred by Chesapeake and its affiliates or the Shareholders, as the case may be (the "Indemnified Party"), the party from whom indemnification is sought (the "Indemnifying Party") may, at its own expense, participate in and, upon notice to the Indemnified Party undertake the defense thereof by counsel of its own choosing, which counsel shall be reasonably satisfactory to the Indemnified Party, provided that, if in the Indemnified Party's reasonable judgment a conflict of interest may exist between such Indemnified Party and the Indemnifying Party with respect to such Third Party Claim, such Indemnified Party shall be entitled to select counsel of its own choosing to defend the Third Party Claim (with the fees and costs of such counsel being at the Indemnifying Party's sole cost and expense); (ii) if (A) within a reasonable time after written notice to the Indemnifying Party of a Third Party Claim, the Indemnifying Party fails to notify the Indemnified Party that it will assume the defense of the Third Party Claim or (B) within a reasonable time after written notice to the Indemnified Party of its intention to undertake the defense of any Third Party Claim, the Indemnifying Party fails to defend the Indemnified Party, the Indemnified Party will have the right to undertake the defense, compromise or settlement of such Third Party Claim for the account and at the risk of the Indemnifying Party; (iii) anything in this Section 9.2(c) to the contrary notwithstanding, if there is a reasonable probability in the Indemnified Party's judgment that a claim may materially and adversely affect the Indemnified Party, other than as a result of money damages or other money payments, the Indemnified Party will have the right to defend, co-defend, compromise or settle such Third Party Claim (with full disclosure of the proposed settlement terms being given to the Indemnifying Party prior to settlement thereof) by selecting counsel of its own choosing (with the fees and costs of such counsel being the Indemnified Party's sole cost and expense); (iv) the Indemnified Party shall cooperate fully in all reasonable respects with the Indemnifying Party in any such defense, compromise or settlement including, without limitation, by making available to the Indemnifying Party all pertinent information and all books and records under the control of the Indemnified Party; (v) the Indemnifying Party shall not compromise or settle any such action, suit, proceeding, claim or demand without the prior written approval of the Indemnified Party; provided that, if such prior written approval is unreasonably withheld by the Indemnified Party, the liability of the Indemnifying Party with respect to such action, suit, proceeding, claim or demand shall be limited to the amount of the settlement recommended by the Indemnifying Party and not approved by the Indemnified Party.

(d) Limitations. The Indemnified Party shall have no claim for indemnification hereunder or other claims against the Indemnifying Party with respect to

this Agreement (other than a claim arising out of the knowing, fraudulent or intentional breach of any provision of this Agreement) unless such claim is identified:

(i) with respect to claims relating to Sections 3.11 and 4.16 within the relevant statute of limitations for assessment and collection of additional taxes; or

(ii) with respect to all other claims, within the earlier of (A) one (1) year following the Effective Time or (B) the date on which an independent audit report on Chesapeake is issued which reflects the Merger.

If such a claim for indemnification or such other recourse is not identified in writing within the appropriate time period provided above, such claim against and right to indemnification from the Indemnifying Party shall be deemed released, waived and relinquished for all purposes. Notwithstanding any other provisions of this Section 9.2 or other provisions of this Agreement to the contrary (except as expressly stated in Section 5.7 and Article XI hereof), no indemnification shall be payable to an Indemnified Party by an Indemnifying Party unless the total of all claims for indemnification by an Indemnified Party under this Agreement shall exceed \$500,000 in the aggregate, whereupon the excess of the amount of such claims over \$500,000 shall be recoverable in accordance with the terms hereof, subject to the maximum amounts set forth in Section 9.2(e).

(e) Maximum Amount of Indemnification. The maximum amount payable to Chesapeake by the Shareholders in the aggregate pursuant to this Section 9.2 shall be \$500,000 and the maximum amount payable by each Shareholder shall be such Shareholder's proportionate ownership percentage of the outstanding Xeron Common Stock immediately prior to the Merger multiplied by \$500,000. The maximum amount payable to the Shareholders, in the aggregate, by Chesapeake pursuant to this Section 9.2, shall be \$500,000. Notwithstanding the foregoing provisions, the respective maximum amounts shall not be applicable to amounts owed arising out of the knowing, fraudulent or intentional breach of any provision of this Agreement by an Indemnifying Party. Furthermore, in no event shall Chesapeake be obligated to pay the Shareholders any indemnification if the market price of Chesapeake Common Stock for the last day of the preceding month end is \$17 per share or above, as adjusted for stock splits, stock dividends and similar events.

(f) Reimbursement in Stock. Amounts due to Chesapeake under this Article IX shall be paid first in Chesapeake Common Stock and, to the extent the Shareholders do not hold sufficient shares of Chesapeake Common Stock to pay the amount due, then in cash. For purposes of this Section 9.2(f), the value of such Chesapeake Common Stock shall be deemed to be the closing price of Chesapeake Common Stock on the New York Stock Exchange on the day the Effective Time occurs

(or the next succeeding trading day on which shares are sold if none are sold on the day the Effective Time occurs).

## ARTICLE X TERMINATION AND AMENDMENT

SECTION 10.1 Termination. This Agreement may be terminated at any time prior to the Effective Time:

- (a) by mutual consent of Chesapeake and the Sellers;
- (b) by either Chesapeake or the Sellers, if the Merger shall not have been consummated before May 31, 1998 (unless the failure to consummate the Merger by such date shall be due to the action or failure to act of the party seeking to terminate); or
- (c) by either Chesapeake or the Sellers, if any permanent injunction or other order of a court or other competent authority preventing the consummation of the Merger shall have become final and nonappealable.

SECTION 10.2 Effect of Termination. In the event of the termination and abandonment of this Agreement pursuant to Section 10.1 hereof, this Agreement shall forthwith become void and have no effect, without any liability on the part of any party hereto or its affiliates, directors, officers or shareholders. Notwithstanding the foregoing, nothing contained in this Section 10.2 shall relieve any party from liability for any material breach of any covenant of this Agreement or any material breach or misrepresentation of the representations or warranties contained herein, which occurred prior to such termination.

SECTION 10.3 Amendment. This Agreement may be amended by the parties hereto at any time prior to the Effective Time. This Agreement may not be amended except by an instrument in writing signed by or on behalf of each of the parties hereto.

SECTION 10.4 Extension; Waiver. At any time prior to the Effective Time, the parties may, to the extent legally allowed, (i) extend the time for the performance of any of the obligations or other acts of the other parties hereto, (ii) waive any inaccuracies in the representations and warranties of the other parties hereto contained herein or in any document delivered pursuant hereto and (iii) waive compliance with any of the agreements or conditions contained herein by the other parties hereto. Any agreement on the part of a party hereto to any such extension or waiver shall be valid only if set forth in a written instrument signed on behalf of such party.

ARTICLE XI  
NON-COMPETITION AGREEMENT

SECTION 11.1 Covenant Not to Solicit Customers. Hire Employees or Compete. For and in consideration of the purchase of Xeron and in addition to any non-competition agreements in the Employment Agreements attached as Annex B hereto, each of the Shareholders agrees that he will not, for a period of three years following the Effective Time:

(a) directly or indirectly, on his own behalf or on behalf of any other person or entity other than Chesapeake, solicit, or attempt to solicit, for the purpose of providing any product or service of the same or similar kind or character as any product or service sold, provided or under development by Xeron prior to the Effective Date, any person or entity that is or was a customer or a prospective customer of Xeron.

(b) directly or indirectly, on his own behalf or on behalf of any other person or entity other than Chesapeake, solicit for employment or hire any employee or former employee of Xeron or any affiliate of Xeron who is or was employed by Xeron or any affiliate during the twelve months preceding the Effective Date.

(c) (i) directly or indirectly engage in, (ii) have any interest in any person, firm, corporation or other entity that directly or indirectly engages in, or (iii) perform any services for any person, firm, corporation or other entity that directly or indirectly engages in, the same or similar lines of business as Xeron, except for such Shareholders' ownership of the stock of Chesapeake, except for ownership of interests in publicly traded companies where such ownership represents less than one percent of the outstanding shares of such publicly traded company.

Nothing in this Section 11.1 is intended or shall restrict the right of any Shareholder to engage in speculative transactions in propane futures traded on a public exchange for his own individual investment account (or the investment account of a member of his immediate family) and not for the benefit of any third party, provided that any such transaction shall be permitted only if (1) executed on a public exchange and (2) such transaction shall not have an adverse effect on Xeron. This Article XI and any claims for breach hereof are not subject to the limitations set forth in Article IX.

ARTICLE XII  
MISCELLANEOUS

SECTION 12.1 Notices. All notices and other communications hereunder shall be in writing, and shall be deemed given upon receipt if delivered personally, sent by facsimile transmission (receipt of which is confirmed) or by certified or registered mail, return receipt requested, or by a nationally recognized private overnight courier to

the parties at the following addresses (or at such other address for a party as shall be specified by like notice):

(a) if to the Shareholders, to:

J. Phillip Keeter  
1405 Colony Circle  
Longview, TX 75604  
Fax: (903) 236-6807

Earnest A. Allen, Jr.  
3126 Robinson Road  
Missouri City, TX 77459

Patrick E. Armand  
9119 Devoncroft  
Houston, TX 77037

(b) if to Xeron, to

Xeron, Inc.  
9301 Southwest Freeway, Suite 325  
Houston, TX 77074  
Attn: Earnest A. Allen, Jr.  
Fax: (713) 988-3476

with a copy to:

J. Richard Millikin, Jr.  
Lowrey & Millikin, L.L.P.  
1127 Judson Road, Suite 141  
Longview, TX 75601  
Fax: (903) 236-3050

(c) if to Chesapeake, to:

Chesapeake Utilities Corporation  
909 Silver Lake Boulevard  
Dover, Delaware 19904  
Attention: John R. Schimkaitis  
Fax: (302) 734-6750

with a copy to:

Covington & Burling  
1201 Pennsylvania Avenue, N.W.  
Washington, D.C. 20004  
Attention: Ruth S. Epstein  
Fax: (202) 662-6291

SECTION 12.2 Descriptive Headings. The descriptive headings herein are inserted for convenience only and are not intended to be part of or to affect the meaning or interpretation of this Agreement.

SECTION 12.3 Counterparts. This Agreement may be executed in two or more counterparts, all of which shall be considered one and the same agreement and shall become effective when two or more counterparts have been signed by each of the parties and delivered to the other parties, it being understood that all parties need not sign the same counterpart.

SECTION 12.4 Entire Agreement; Assignment. This Agreement (a) constitutes the entire agreement and supersedes all prior agreements and understandings, both written and oral, among the parties with respect to the subject matter hereof and (b) shall not be assigned by operation of law or otherwise.

SECTION 12.5 Governing Law. This Agreement shall be governed and construed in accordance with the laws of the State of Delaware without regard to any applicable principles of conflicts of law.

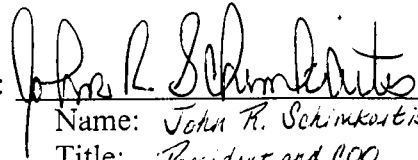
SECTION 12.6 Specific Performance. The parties hereto agree that if any of the provisions of this Agreement were not performed in accordance with their specific terms or were otherwise breached, irreparable damage would occur, no adequate remedy at law would exist and damages would be difficult to determine, and that the parties shall be entitled to specific performance of the terms hereof, in addition to any other remedy at law or equity.

SECTION 12.7 Publicity. Chesapeake may issue or cause the publication of any press release or other public announcement or make any filing with the SEC with respect to the transactions contemplated by this Agreement as it deems appropriate; provided that, to the extent practicable, Chesapeake shall provide the Shareholders with a copy of any such press release or other public announcement or filing prior to the time of release or filing. The Sellers shall not issue or cause the publication of any press release or other public announcement with respect to the transactions contemplated by this Agreement without the prior approval of Chesapeake.

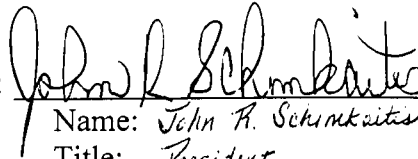
SECTION 12.8 Parties in Interest. This Agreement shall be binding upon and inure solely to the benefit of each party hereto and nothing in this Agreement, express or implied, is intended to or shall confer upon any other person or persons any rights, benefits or remedies of any nature whatsoever under or by reason of this Agreement.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be signed (where applicable by their respective officers thereunto duly authorized), as of the date first written above.

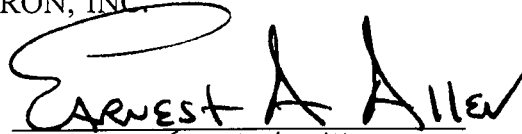
CHESAPEAKE UTILITIES CORPORATION

By:   
Name: John R. Schinkowitz  
Title: President and CEO

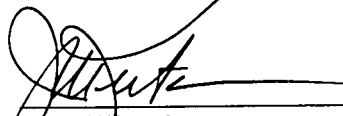
CPK-SUB-C, INC.

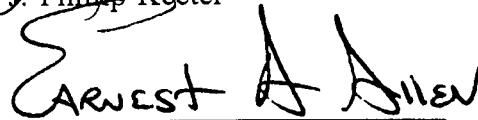
By:   
Name: John R. Schinkowitz  
Title: President

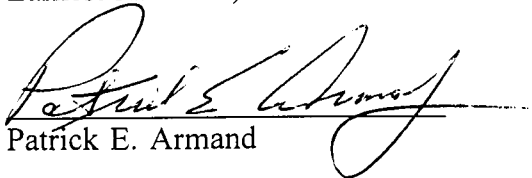
XERON, INC.

By:   
Name: Ernest A. Allen  
Title: CEO

SHAREHOLDERS

  
J. Phillip Keeter

  
Ernest A. Allen, Jr.

  
Patrick E. Armand



## AMENDMENT TO AGREEMENT AND PLAN OF MERGER

THIS AMENDMENT TO AGREEMENT AND PLAN OF MERGER (the "Amendment") is entered into this 28th day of May, 1998, by and among Chesapeake Utilities Corporation, a Delaware corporation ("Chesapeake"); CPK Sub-C, Inc., a Delaware corporation and a wholly owned subsidiary of Chesapeake ("CPK Sub-C"); Xeron, Inc., a Mississippi corporation ("Xeron"); J. Phillip Keeter, Earnest A. Allen, Jr. and Patrick E. Armand, residents of Texas (each individually a "Shareholder," together, the "Shareholders," and with Xeron collectively, the "Sellers").

### W I T N E S S

WHEREAS, Chesapeake, CPK Sub-C, and the Sellers are parties to a certain Agreement and Plan of Merger dated April 28, 1998; and

WHEREAS, Section 10.3 of the Agreement and Plan of Merger allows for amendments prior to the effective time,

NOW THEREFORE, Chesapeake, CPK Sub-C, and the Sellers hereby agree to the following amendments to the Agreement and Plan of Merger:

1. Paragraph (c) of SECTION 1.6 shall be deleted and replaced in its entirety with the following paragraph:

"(c) The issued and outstanding shares of capital stock of CPK Sub-C shall be converted into and become, in the aggregate, 500 fully paid and non-assessable shares of common stock of the Surviving Corporation."

2. SECTION 4.18 of the Agreement and Plan of Merger shall be deleted and replaced in its entirety with the following provision:


"SECTION 4.18 Related Party Contracts. Except as set forth in Section 4.18 of the Chesapeake Disclosure Schedule or the Chesapeake SEC Reports, Chesapeake has no agreements, arrangements or commitments with related parties (including shareholders, directors and officers), other than the related-party agreements described in Section 4.21 of the Chesapeake Disclosure Schedule. Except as set forth in Section 4.18 of the Chesapeake Disclosure Schedule, each of the related-party agreements was entered into between Chesapeake and the party thereto on an arm's length basis on terms no less favorable to Chesapeake than it could obtain from an unrelated third party."

3. SECTION 1.5 shall be deleted and replaced in its entirety with the following provision:


"SECTION 1.5 Officers. The officers of CPK Sub-C immediately prior to the effective time and Carl E. Mendenhall shall be the initial officers of the surviving corporation and shall serve as the officers of the Surviving Corporation at the pleasure of the board of directors of the Surviving Corporation."

IN WITNESS WHEREOF, the parties hereto have caused this Amendment to be signed (where applicable by their respective officers thereunto duly authorized), as of the date first written above.

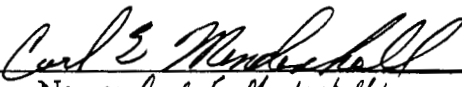
CHESAPEAKE UTILITIES CORPORATION

By:   
Name: John R. Schinkaitis  
Title: President

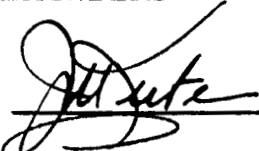
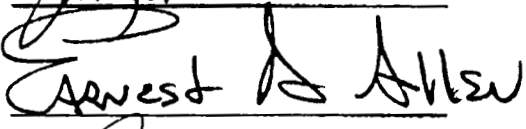
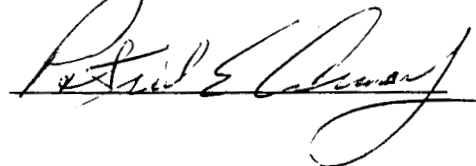
CPK SUB-C, INC.

By:   
Name: John R. Schinkaitis  
Title: President

XERON, INC.

By:   
Name: Carl E. Mendenhall  
Title: President

SHAREHOLDERS

## REGISTRATION RIGHTS AGREEMENT

This Registration Rights Agreement (the "Agreement") is made and entered into as of May 29, 1998, by and between Chesapeake Utilities Corporation, a Delaware corporation (the "Company") and J. Phillip Keeter ("Shareholder").

This Agreement is made as contemplated by that certain Agreement and Plan of Merger dated as of April 28, 1998, by and among the Company, CPK Sub-C, Inc., a Delaware corporation and wholly-owned subsidiary of the Company ("CPK Sub-C"), Xeron, Inc., a Mississippi corporation ("Xeron"), J. Phillip Keeter, Earnest A. Allen, Jr., and Patrick Armand (the "Merger Agreement"), which provides for the merger of CPK Sub-C with and into Xeron (the "Merger"). Whereas the securities to be delivered to Shareholder pursuant to the Merger Agreement are restricted securities, as defined in Rule 144 under the Securities Act of 1933, in order to induce Xeron and Shareholder to enter into the Merger Agreement, the Company has agreed to provide the registration rights set forth in this Agreement.

For good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the parties hereby agree as follows:

1. Securities Subject to this Agreement. The securities entitled to the benefits of this Agreement are the shares of common stock, par value \$.4867 per share, of the Company (the "Common Stock") issued to Shareholder in accordance with the terms of the Merger Agreement (the "Registrable Securities").

2. Registration.

(a) Within 60 days following the time at which results covering at least 30 days of post-Merger combined operations of the Company have been filed with the Securities and Exchange Commission (the "Commission"), sent to stockholders of the Company or otherwise publicly issued, the Company will, subject to the terms of this Agreement, and subject to the full cooperation of Shareholder, at its expense, file with the Commission a registration statement (the "Registration Statement") covering the sale by Shareholder of the Registrable Securities. The Company will use its reasonable best efforts to cause the Registration Statement to become effective as promptly as practicable and to maintain the effectiveness of the Registration Statement for a period of three (3) years from the Effective Time, as that term is defined in the Merger Agreement, or such shorter time as may be required by Rule 144(k) under the Securities Act of 1933, as amended (the "Securities Act"), or any successor provision. The Company may postpone for a reasonable period of time, not to exceed 60 days, the filing or effectiveness of the Registration Statement, or the undertaking of any work by the Company with respect to the preparation of the Registration Statement, if the Board of Directors of the

Company in good faith determines that such filing or registration would reasonably be expected to have a material adverse effect on any plan or proposal by the Company with respect to any financing, acquisition, recapitalization, reorganization or other material transaction.

(b) Before filing with the Commission the Registration Statement or any amendments or supplements thereto, the Company will furnish to Shareholder for review copies of all documents proposed to be filed.

(c) The Company shall furnish to Shareholder such number of copies of the Registration Statement and of each amendment and supplement thereto (in each case including all exhibits), such number of copies of the prospectus included in such Registration Statement (including each preliminary prospectus and summary prospectus), and such other documents as Shareholder may reasonably request in order to facilitate the disposition of the Registrable Securities by Shareholder.

(d) The Company shall use its best efforts to register or qualify the Registrable Securities covered by the Registration Statement under such other securities or blue sky laws of such jurisdictions as Shareholder may reasonably request, provided that the Company shall not for any such purpose be required to qualify generally to do business as a foreign corporation in any jurisdiction where, but for the requirements of this Section 2(d), it would not be obligated to be so qualified, to subject itself to taxation in any such jurisdiction, or to consent to general service of process in any such jurisdiction (a general service of process would not include a consent on Form U-2 or its substantial equivalent).

(e) The Company may require Shareholder to furnish the Company with such information regarding Shareholder and pertinent to the disclosure requirements relating to the registration and the distribution of the Registrable Securities as the Company may from time to time reasonably request.

(f) If Shareholder determines to distribute the Registrable Securities in an underwritten offering, all costs, fees, and disbursements of underwriters and all underwriting discounts, commissions and transfer taxes relating to such distribution will be the sole responsibility of Shareholder.

(g) Shareholder agrees that upon notice from the Company he will suspend from time to time all sales of the Registrable Securities for such period of time as is required to permit the Company to complete any future financing transaction involving an underwritten offering by the Company of its Common Stock. Shareholder will not be required to suspend sales of the Registrable

Securities (pursuant to this Section 2(g)) for more than three months in any 12-month period.

(h) Shareholder agrees that, upon receipt of any notice from the Company that the Company has become aware that the prospectus included in the Registration Statement, as then in effect, includes an untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading in the light of the circumstances then existing, Shareholder will forthwith discontinue disposition of Registrable Securities pursuant to the Registration Statement until Shareholder's receipt of copies of a properly supplemented or amended prospectus and, if so directed by the Company, Shareholder will deliver to the Company all copies, other than permanent file copies then in Shareholder's possession, of the prospectus covering Registrable Securities current at the time of receipt of such notice. The Company will diligently prepare an amended prospectus and deliver sufficient copies thereof to Shareholder.

3. Indemnification.

(a) Indemnification by the Company. The Company will indemnify and hold harmless, to the extent permitted by law, Shareholder against any and all losses, claims, damages or liabilities, joint or several, to which Shareholder may become subject under the Securities Act or otherwise, insofar as such losses, claims, damages or liabilities (or actions or proceedings, whether commenced or threatened, in respect thereof) arise out of or are based upon any untrue statement or alleged untrue statement of any material fact contained in the Registration Statement, any preliminary prospectus, final prospectus or summary prospectus contained therein, or any amendment or supplement thereto, or any omission or alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading, and subject to the provisions of Section 3(c), the Company will reimburse Shareholder for any legal or any other expenses reasonably incurred by it in connection with investigating or defending any such loss, claim, liability, action or proceeding; provided, however, that the Company shall not be liable to Shareholder in any such case to the extent that any such loss, claim, damage, liability (or action or proceeding in respect thereof) or expense arises out of or is based upon an untrue statement or alleged untrue statement or omission or alleged omission made in the Registration Statement, any such preliminary prospectus, final prospectus, summary prospectus, amendment or supplement thereto in reliance upon and in conformity with information furnished to the Company by Shareholder for use in the preparation thereof; and provided further that the Company shall not be liable under this Section 3(a) to Shareholder to the extent that any such loss, claim, damage, liability (or action or proceeding in

respect thereof) or expense arises out of Shareholder's failure to send or give a copy of the final prospectus, as the same may be then supplemented or amended, to the person asserting an untrue statement or alleged untrue statement or omission or alleged omission at or prior to the written confirmation of the sale of Registrable Securities to such person if such statement or omission was corrected in such final prospectus. Such indemnity shall remain in full force and effect regardless of any investigation made by or on behalf of Shareholder and shall survive the transfer of such securities by Shareholder.

(b) Indemnification by Shareholder. Shareholder will indemnify and hold harmless (in the same manner and to the same extent as set forth in subdivision (a) of this Section 3) the Company, each director of the Company and each officer of the Company with respect to any statement or alleged statement in or omission or alleged omission from the Registration Statement, any preliminary prospectus, final prospectus or summary prospectus contained therein, or any amendment or supplement thereto, if such statement or alleged statement or omission or alleged omission was made in reliance upon and in conformity with information furnished to the Company by Shareholder for use in the preparation of the Registration Statement, preliminary prospectus, final prospectus, summary prospectus, amendment or supplement thereto. Such indemnity shall remain in full force and effect, regardless of any investigation made by or on behalf of the Company, any director of the Company or any officer of the Company and shall survive the transfer of such securities by Shareholder.

(c) Notice of Claims, etc. Promptly after receipt by an indemnified party of notice of the commencement of any action or proceeding or threat of claim involving a claim referred to in the preceding subdivisions of this Section 3, such indemnified party will, if a claim in respect thereof is to be made against an indemnifying party, give written notice to the latter of the commencement of such action or threat of claim, provided that the failure of any indemnified party to give notice as provided herein shall not relieve the indemnifying party of its obligations under the preceding subdivisions of this Section 3, except to the extent that the indemnifying party is prejudiced by such failure to give notice. In case any such action is brought against an indemnified party, unless and except to the extent that in the reasonable judgment of the indemnified party, based on advice of counsel, a conflict of interest between such indemnified and indemnifying parties exists in respect of such claim, the indemnifying party shall be entitled to participate in and to assume the defense thereof, jointly with any other indemnifying party similarly notified, to the extent that the indemnifying party may wish, with counsel reasonably satisfactory to such indemnified party, and after notice from the indemnifying party to such indemnified party of its election so to assume the defense thereof, the indemnifying party shall not be liable to such indemnified party for any legal or

other expenses subsequently incurred by the latter in connection with the defense thereof other than reasonable costs of investigation. No indemnified party shall consent to entry of any judgment or enter into any settlement of any such action the defense of which has been assumed by an indemnifying party without the consent of such indemnifying party.

(d) Indemnification Payments. The indemnification required by this Section 3 shall be made by periodic payments of the amount thereof during the course of the investigation or defense, as and when bills are received or expense, loss, damage or liability is incurred subject to the receipt of such documentary support therefor as the indemnifying party may reasonably request.

(e) Contribution. If the indemnification provided for in this Section 3 shall for any reason be unavailable to an indemnified party in respect of any loss, claim, damage or liability, or any action in respect thereof, referred to therein, then each indemnifying party shall, in lieu of indemnifying such indemnified party, contribute to the amount paid or payable by such indemnified party as a result of such loss, claim, damage or liability, or action in respect thereof, in such proportion as shall be appropriate to reflect the relative fault of the indemnifying party on the one hand and the indemnified party on the other with respect to the statements or omission which resulted in such loss, claim, damage or liability, or action in respect thereof, as well as any other relevant equitable considerations. The relative fault shall be determined by reference to whether the untrue or alleged untrue statement of a material fact or omission or alleged omission to state a material fact relates to information supplied by the indemnifying party on the one hand or the indemnified party on the other, the intent of the parties and their relative knowledge, access to information and opportunity to correct or prevent such statement or omission, but not by reference to an indemnified party's stock ownership in the Company. The amount paid or payable by an indemnified party as a result of the loss, claim, damage or liability, or action in respect thereof, referred to above in this paragraph shall be deemed to include, for purposes of this paragraph, any legal or other expenses reasonably incurred by such indemnified party in connection with investigating or defending any such action or claim. No person guilty of fraudulent misrepresentation (within the meaning of Section 12(f) of the Securities Act) shall be entitled to contribution from any person who was not guilty of such fraudulent misrepresentation.

4. Restriction on Transfer.

(a) Shareholder covenants and agrees that in any calendar quarter he will not offer to sell, sell or otherwise dispose of any amount of

Registrable Securities in excess of one percent (1%) of the total number of shares of Common Stock then issued and outstanding.

(b) Notwithstanding the provisions of Section 4(a) of this Agreement, in the event that a Shareholder becomes liable for a payment obligation under the indemnification provisions of the Merger Agreement, Shareholder may, at his option, sell or pledge in accordance with the Registration Statement as then in effect or pursuant to an applicable exemption from registration, such number of shares of the Registrable Securities sufficient to generate net funds in the amount of that payment obligation.

5. Notices. Any notices or other communications required or permitted hereunder shall be in writing and shall be deemed duly given upon (a) confirmed delivery by a standard overnight carrier or when delivered by hand, or (b) the expiration of five business days after the day when mailed by certified or registered mail, postage prepaid, addressed at the following addresses (or at such other address as the parties hereto shall specify by like notice):

(x) If to the Company, to:

Chesapeake Utilities Corporation  
909 Silver Lake Boulevard  
Dover, Delaware 19904  
Attention: John R. Schimkaitis

with a copy to:

Covington & Burling  
1201 Pennsylvania Avenue, N.W.  
Post Office Box 7566  
Washington, D.C. 20044  
Attention: Ruth S. Epstein

(y) If to Shareholder, to the most recent address given by Shareholder to the Company, which address initially appears below his signature.


6. Miscellaneous. This Agreement and any term hereof may be changed, waived, discharged or terminated only by an instrument in writing, signed by the party against which enforcement of such change, waiver, discharge or termination is sought or by Shareholder and the Company. This Agreement shall be construed and enforced in accordance with and governed by the laws of the State of



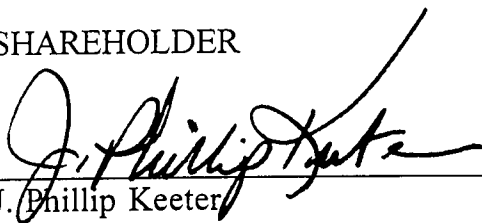
Delaware. The section headings in this Agreement are for purposes of convenience only and shall not constitute a part hereof.

IN WITNESS WHEREOF, the Company and Shareholder have caused this Agreement to be duly executed as of the date first above written.

CHESAPEAKE UTILITIES CORPORATION

By:   
John R. Schimkaitis  
President

SHAREHOLDER

  
J. Phillip Keeter

Address      1405 Colony Circle  
Longview, TX 75604

## **REGISTRATION RIGHTS AGREEMENT**

This Registration Rights Agreement (the "Agreement") is made and entered into as of May 29, 1998, by and between Chesapeake Utilities Corporation, a Delaware corporation (the "Company") and Earnest A. Allen, Jr. ("Shareholder").

This Agreement is made as contemplated by that certain Agreement and Plan of Merger dated as of April 28, 1998, by and among the Company, CPK Sub-C, Inc., a Delaware corporation and wholly-owned subsidiary of the Company ("CPK Sub-C"), Xeron, Inc., a Mississippi corporation ("Xeron"), J. Phillip Keeter, Earnest A. Allen, Jr., and Patrick Armand (the "Merger Agreement"), which provides for the merger of CPK Sub-C with and into Xeron (the "Merger"). Whereas the securities to be delivered to Shareholder pursuant to the Merger Agreement are restricted securities, as defined in Rule 144 under the Securities Act of 1933, in order to induce Xeron and Shareholder to enter into the Merger Agreement, the Company has agreed to provide the registration rights set forth in this Agreement.

For good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the parties hereby agree as follows:

1. Securities Subject to this Agreement. The securities entitled to the benefits of this Agreement are the shares of common stock, par value \$.4867 per share, of the Company (the "Common Stock") issued to Shareholder in accordance with the terms of the Merger Agreement (the "Registrable Securities").

2. Registration.

(a) Within 60 days following the time at which results covering at least 30 days of post-Merger combined operations of the Company have been filed with the Securities and Exchange Commission (the "Commission"), sent to stockholders of the Company or otherwise publicly issued, the Company will, subject to the terms of this Agreement, and subject to the full cooperation of Shareholder, at its expense, file with the Commission a registration statement (the "Registration Statement") covering the sale by Shareholder of the Registrable Securities. The Company will use its reasonable best efforts to cause the Registration Statement to become effective as promptly as practicable and to maintain the effectiveness of the Registration Statement for a period of three (3) years from the Effective Time, as that term is defined in the Merger Agreement, or such shorter time as may be required by Rule 144(k) under the Securities Act of 1933, as amended (the "Securities Act"), or any successor provision. The Company may postpone for a reasonable period of time, not to exceed 60 days, the filing or effectiveness of the Registration Statement, or the undertaking of any work by the Company with respect to the preparation of the Registration Statement, if the Board of Directors of the

Securities (pursuant to this Section 2(g)) for more than three months in any 12-month period.

(h) Shareholder agrees that, upon receipt of any notice from the Company that the Company has become aware that the prospectus included in the Registration Statement, as then in effect, includes an untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading in the light of the circumstances then existing, Shareholder will forthwith discontinue disposition of Registrable Securities pursuant to the Registration Statement until Shareholder's receipt of copies of a properly supplemented or amended prospectus and, if so directed by the Company, Shareholder will deliver to the Company all copies, other than permanent file copies then in Shareholder's possession, of the prospectus covering Registrable Securities current at the time of receipt of such notice. The Company will diligently prepare an amended prospectus and deliver sufficient copies thereof to Shareholder.

3. Indemnification.

(a) Indemnification by the Company. The Company will indemnify and hold harmless, to the extent permitted by law, Shareholder against any and all losses, claims, damages or liabilities, joint or several, to which Shareholder may become subject under the Securities Act or otherwise, insofar as such losses, claims, damages or liabilities (or actions or proceedings, whether commenced or threatened, in respect thereof) arise out of or are based upon any untrue statement or alleged untrue statement of any material fact contained in the Registration Statement, any preliminary prospectus, final prospectus or summary prospectus contained therein, or any amendment or supplement thereto, or any omission or alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading, and subject to the provisions of Section 3(c), the Company will reimburse Shareholder for any legal or any other expenses reasonably incurred by it in connection with investigating or defending any such loss, claim, liability, action or proceeding; provided, however, that the Company shall not be liable to Shareholder in any such case to the extent that any such loss, claim, damage, liability (or action or proceeding in respect thereof) or expense arises out of or is based upon an untrue statement or alleged untrue statement or omission or alleged omission made in the Registration Statement, any such preliminary prospectus, final prospectus, summary prospectus, amendment or supplement thereto in reliance upon and in conformity with information furnished to the Company by Shareholder for use in the preparation thereof; and provided further that the Company shall not be liable under this Section 3(a) to Shareholder to the extent that any such loss, claim, damage, liability (or action or proceeding in

respect thereof) or expense arises out of Shareholder's failure to send or give a copy of the final prospectus, as the same may be then supplemented or amended, to the person asserting an untrue statement or alleged untrue statement or omission or alleged omission at or prior to the written confirmation of the sale of Registrable Securities to such person if such statement or omission was corrected in such final prospectus. Such indemnity shall remain in full force and effect regardless of any investigation made by or on behalf of Shareholder and shall survive the transfer of such securities by Shareholder.

(b) Indemnification by Shareholder. Shareholder will indemnify and hold harmless (in the same manner and to the same extent as set forth in subdivision (a) of this Section 3) the Company, each director of the Company and each officer of the Company with respect to any statement or alleged statement in or omission or alleged omission from the Registration Statement, any preliminary prospectus, final prospectus or summary prospectus contained therein, or any amendment or supplement thereto, if such statement or alleged statement or omission or alleged omission was made in reliance upon and in conformity with information furnished to the Company by Shareholder for use in the preparation of the Registration Statement, preliminary prospectus, final prospectus, summary prospectus, amendment or supplement thereto. Such indemnity shall remain in full force and effect, regardless of any investigation made by or on behalf of the Company, any director of the Company or any officer of the Company and shall survive the transfer of such securities by Shareholder.

(c) Notice of Claims, etc. Promptly after receipt by an indemnified party of notice of the commencement of any action or proceeding or threat of claim involving a claim referred to in the preceding subdivisions of this Section 3, such indemnified party will, if a claim in respect thereof is to be made against an indemnifying party, give written notice to the latter of the commencement of such action or threat of claim, provided that the failure of any indemnified party to give notice as provided herein shall not relieve the indemnifying party of its obligations under the preceding subdivisions of this Section 3, except to the extent that the indemnifying party is prejudiced by such failure to give notice. In case any such action is brought against an indemnified party, unless and except to the extent that in the reasonable judgment of the indemnified party, based on advice of counsel, a conflict of interest between such indemnified and indemnifying parties exists in respect of such claim, the indemnifying party shall be entitled to participate in and to assume the defense thereof, jointly with any other indemnifying party similarly notified, to the extent that the indemnifying party may wish, with counsel reasonably satisfactory to such indemnified party, and after notice from the indemnifying party to such indemnified party of its election so to assume the defense thereof, the indemnifying party shall not be liable to such indemnified party for any legal or

other expenses subsequently incurred by the latter in connection with the defense thereof other than reasonable costs of investigation. No indemnified party shall consent to entry of any judgment or enter into any settlement of any such action the defense of which has been assumed by an indemnifying party without the consent of such indemnifying party.

(d) Indemnification Payments. The indemnification required by this Section 3 shall be made by periodic payments of the amount thereof during the course of the investigation or defense, as and when bills are received or expense, loss, damage or liability is incurred subject to the receipt of such documentary support therefor as the indemnifying party may reasonably request.

(e) Contribution. If the indemnification provided for in this Section 3 shall for any reason be unavailable to an indemnified party in respect of any loss, claim, damage or liability, or any action in respect thereof, referred to therein, then each indemnifying party shall, in lieu of indemnifying such indemnified party, contribute to the amount paid or payable by such indemnified party as a result of such loss, claim, damage or liability, or action in respect thereof, in such proportion as shall be appropriate to reflect the relative fault of the indemnifying party on the one hand and the indemnified party on the other with respect to the statements or omission which resulted in such loss, claim, damage or liability, or action in respect thereof, as well as any other relevant equitable considerations. The relative fault shall be determined by reference to whether the untrue or alleged untrue statement of a material fact or omission or alleged omission to state a material fact relates to information supplied by the indemnifying party on the one hand or the indemnified party on the other, the intent of the parties and their relative knowledge, access to information and opportunity to correct or prevent such statement or omission, but not by reference to an indemnified party's stock ownership in the Company. The amount paid or payable by an indemnified party as a result of the loss, claim, damage or liability, or action in respect thereof, referred to above in this paragraph shall be deemed to include, for purposes of this paragraph, any legal or other expenses reasonably incurred by such indemnified party in connection with investigating or defending any such action or claim. No person guilty of fraudulent misrepresentation (within the meaning of Section 12(f) of the Securities Act) shall be entitled to contribution from any person who was not guilty of such fraudulent misrepresentation.

4. Restriction on Transfer.

(a) Shareholder covenants and agrees that in any calendar quarter he will not offer to sell, sell or otherwise dispose of any amount of

Registrable Securities in excess of one percent (1%) of the total number of shares of Common Stock then issued and outstanding.

(b) Notwithstanding the provisions of Section 4(a) of this Agreement, in the event that a Shareholder becomes liable for a payment obligation under the indemnification provisions of the Merger Agreement, Shareholder may, at his option, sell or pledge in accordance with the Registration Statement as then in effect or pursuant to an applicable exemption from registration, such number of shares of the Registrable Securities sufficient to generate net funds in the amount of that payment obligation.

5. Notices. Any notices or other communications required or permitted hereunder shall be in writing and shall be deemed duly given upon (a) confirmed delivery by a standard overnight carrier or when delivered by hand, or (b) the expiration of five business days after the day when mailed by certified or registered mail, postage prepaid, addressed at the following addresses (or at such other address as the parties hereto shall specify by like notice):

(x) If to the Company, to:

Chesapeake Utilities Corporation  
909 Silver Lake Boulevard  
Dover, Delaware 19904  
Attention: John R. Schimkaitis

with a copy to:

Covington & Burling  
1201 Pennsylvania Avenue, N.W.  
Post Office Box 7566  
Washington, D.C. 20044  
Attention: Ruth S. Epstein

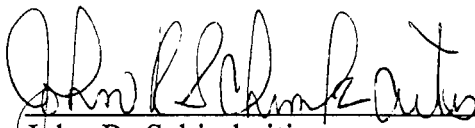
(y) If to Shareholder, to the most recent address given by Shareholder to the Company, which address initially appears below his signature.

6. Miscellaneous. This Agreement and any term hereof may be changed, waived, discharged or terminated only by an instrument in writing, signed by the party against which enforcement of such change, waiver, discharge or termination is sought or by Shareholder and the Company. This Agreement shall be construed and enforced in accordance with and governed by the laws of the State of


Delaware. The section headings in this Agreement are for purposes of convenience only and shall not constitute a part hereof.

IN WITNESS WHEREOF, the Company and Shareholder have caused this Agreement to be duly executed as of the date first above written.

CHESAPEAKE UTILITIES CORPORATION

By:   
John R. Schimkaitis  
President

SHAREHOLDER

  
Ernest A. Allen, Jr.

Address      3126 Robinson Road  
                 Missouri City, TX 77459  
                 \_\_\_\_\_

## REGISTRATION RIGHTS AGREEMENT

This Registration Rights Agreement (the "Agreement") is made and entered into as of May 29, 1998, by and between Chesapeake Utilities Corporation, a Delaware corporation (the "Company") and Patrick E. Armand ("Shareholder").

This Agreement is made as contemplated by that certain Agreement and Plan of Merger dated as of April 28, 1998, by and among the Company, CPK Sub-C, Inc., a Delaware corporation and wholly-owned subsidiary of the Company ("CPK Sub-C"), Xeron, Inc., a Mississippi corporation ("Xeron"), J. Phillip Keeter, Earnest A. Allen, Jr., and Patrick Armand (the "Merger Agreement"), which provides for the merger of CPK Sub-C with and into Xeron (the "Merger"). Whereas the securities to be delivered to Shareholder pursuant to the Merger Agreement are restricted securities, as defined in Rule 144 under the Securities Act of 1933, in order to induce Xeron and Shareholder to enter into the Merger Agreement, the Company has agreed to provide the registration rights set forth in this Agreement.

For good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the parties hereby agree as follows:

1. Securities Subject to this Agreement. The securities entitled to the benefits of this Agreement are the shares of common stock, par value \$.4867 per share, of the Company (the "Common Stock") issued to Shareholder in accordance with the terms of the Merger Agreement (the "Registrable Securities").

2. Registration.

(a) Within 60 days following the time at which results covering at least 30 days of post-Merger combined operations of the Company have been filed with the Securities and Exchange Commission (the "Commission"), sent to stockholders of the Company or otherwise publicly issued, the Company will, subject to the terms of this Agreement, and subject to the full cooperation of Shareholder, at its expense, file with the Commission a registration statement (the "Registration Statement") covering the sale by Shareholder of the Registrable Securities. The Company will use its reasonable best efforts to cause the Registration Statement to become effective as promptly as practicable and to maintain the effectiveness of the Registration Statement for a period of three (3) years from the Effective Time, as that term is defined in the Merger Agreement, or such shorter time as may be required by Rule 144(k) under the Securities Act of 1933, as amended (the "Securities Act"), or any successor provision. The Company may postpone for a reasonable period of time, not to exceed 60 days, the filing or effectiveness of the Registration Statement, or the undertaking of any work by the Company with respect to the preparation of the Registration Statement, if the Board of Directors of the



Company in good faith determines that such filing or registration would reasonably be expected to have a material adverse effect on any plan or proposal by the Company with respect to any financing, acquisition, recapitalization, reorganization or other material transaction.

(b) Before filing with the Commission the Registration Statement or any amendments or supplements thereto, the Company will furnish to Shareholder for review copies of all documents proposed to be filed.

(c) The Company shall furnish to Shareholder such number of copies of the Registration Statement and of each amendment and supplement thereto (in each case including all exhibits), such number of copies of the prospectus included in such Registration Statement (including each preliminary prospectus and summary prospectus), and such other documents as Shareholder may reasonably request in order to facilitate the disposition of the Registrable Securities by Shareholder.

(d) The Company shall use its best efforts to register or qualify the Registrable Securities covered by the Registration Statement under such other securities or blue sky laws of such jurisdictions as Shareholder may reasonably request, provided that the Company shall not for any such purpose be required to qualify generally to do business as a foreign corporation in any jurisdiction where, but for the requirements of this Section 2(d), it would not be obligated to be so qualified, to subject itself to taxation in any such jurisdiction, or to consent to general service of process in any such jurisdiction (a general service of process would not include a consent on Form U-2 or its substantial equivalent).

(e) The Company may require Shareholder to furnish the Company with such information regarding Shareholder and pertinent to the disclosure requirements relating to the registration and the distribution of the Registrable Securities as the Company may from time to time reasonably request.

(f) If Shareholder determines to distribute the Registrable Securities in an underwritten offering, all costs, fees, and disbursements of underwriters and all underwriting discounts, commissions and transfer taxes relating to such distribution will be the sole responsibility of Shareholder.

(g) Shareholder agrees that upon notice from the Company he will suspend from time to time all sales of the Registrable Securities for such period of time as is required to permit the Company to complete any future financing transaction involving an underwritten offering by the Company of its Common Stock. Shareholder will not be required to suspend sales of the Registrable

Securities (pursuant to this Section 2(g)) for more than three months in any 12-month period.

(h) Shareholder agrees that, upon receipt of any notice from the Company that the Company has become aware that the prospectus included in the Registration Statement, as then in effect, includes an untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading in the light of the circumstances then existing, Shareholder will forthwith discontinue disposition of Registrable Securities pursuant to the Registration Statement until Shareholder's receipt of copies of a properly supplemented or amended prospectus and, if so directed by the Company, Shareholder will deliver to the Company all copies, other than permanent file copies then in Shareholder's possession, of the prospectus covering Registrable Securities current at the time of receipt of such notice. The Company will diligently prepare an amended prospectus and deliver sufficient copies thereof to Shareholder.

3. Indemnification.

(a) Indemnification by the Company. The Company will indemnify and hold harmless, to the extent permitted by law, Shareholder against any and all losses, claims, damages or liabilities, joint or several, to which Shareholder may become subject under the Securities Act or otherwise, insofar as such losses, claims, damages or liabilities (or actions or proceedings, whether commenced or threatened, in respect thereof) arise out of or are based upon any untrue statement or alleged untrue statement of any material fact contained in the Registration Statement, any preliminary prospectus, final prospectus or summary prospectus contained therein, or any amendment or supplement thereto, or any omission or alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading, and subject to the provisions of Section 3(c), the Company will reimburse Shareholder for any legal or any other expenses reasonably incurred by it in connection with investigating or defending any such loss, claim, liability, action or proceeding; provided, however, that the Company shall not be liable to Shareholder in any such case to the extent that any such loss, claim, damage, liability (or action or proceeding in respect thereof) or expense arises out of or is based upon an untrue statement or alleged untrue statement or omission or alleged omission made in the Registration Statement, any such preliminary prospectus, final prospectus, summary prospectus, amendment or supplement thereto in reliance upon and in conformity with information furnished to the Company by Shareholder for use in the preparation thereof; and provided further that the Company shall not be liable under this Section 3(a) to Shareholder to the extent that any such loss, claim, damage, liability (or action or proceeding in

respect thereof) or expense arises out of Shareholder's failure to send or give a copy of the final prospectus, as the same may be then supplemented or amended, to the person asserting an untrue statement or alleged untrue statement or omission or alleged omission at or prior to the written confirmation of the sale of Registrable Securities to such person if such statement or omission was corrected in such final prospectus. Such indemnity shall remain in full force and effect regardless of any investigation made by or on behalf of Shareholder and shall survive the transfer of such securities by Shareholder.

(b) Indemnification by Shareholder. Shareholder will indemnify and hold harmless (in the same manner and to the same extent as set forth in subdivision (a) of this Section 3) the Company, each director of the Company and each officer of the Company with respect to any statement or alleged statement in or omission or alleged omission from the Registration Statement, any preliminary prospectus, final prospectus or summary prospectus contained therein, or any amendment or supplement thereto, if such statement or alleged statement or omission or alleged omission was made in reliance upon and in conformity with information furnished to the Company by Shareholder for use in the preparation of the Registration Statement, preliminary prospectus, final prospectus, summary prospectus, amendment or supplement thereto. Such indemnity shall remain in full force and effect, regardless of any investigation made by or on behalf of the Company, any director of the Company or any officer of the Company and shall survive the transfer of such securities by Shareholder.

(c) Notice of Claims, etc. Promptly after receipt by an indemnified party of notice of the commencement of any action or proceeding or threat of claim involving a claim referred to in the preceding subdivisions of this Section 3, such indemnified party will, if a claim in respect thereof is to be made against an indemnifying party, give written notice to the latter of the commencement of such action or threat of claim, provided that the failure of any indemnified party to give notice as provided herein shall not relieve the indemnifying party of its obligations under the preceding subdivisions of this Section 3, except to the extent that the indemnifying party is prejudiced by such failure to give notice. In case any such action is brought against an indemnified party, unless and except to the extent that in the reasonable judgment of the indemnified party, based on advice of counsel, a conflict of interest between such indemnified and indemnifying parties exists in respect of such claim, the indemnifying party shall be entitled to participate in and to assume the defense thereof, jointly with any other indemnifying party similarly notified, to the extent that the indemnifying party may wish, with counsel reasonably satisfactory to such indemnified party, and after notice from the indemnifying party to such indemnified party of its election so to assume the defense thereof, the indemnifying party shall not be liable to such indemnified party for any legal or

other expenses subsequently incurred by the latter in connection with the defense thereof other than reasonable costs of investigation. No indemnified party shall consent to entry of any judgment or enter into any settlement of any such action the defense of which has been assumed by an indemnifying party without the consent of such indemnifying party.

(d) Indemnification Payments. The indemnification required by this Section 3 shall be made by periodic payments of the amount thereof during the course of the investigation or defense, as and when bills are received or expense, loss, damage or liability is incurred subject to the receipt of such documentary support therefor as the indemnifying party may reasonably request.

(e) Contribution. If the indemnification provided for in this Section 3 shall for any reason be unavailable to an indemnified party in respect of any loss, claim, damage or liability, or any action in respect thereof, referred to therein, then each indemnifying party shall, in lieu of indemnifying such indemnified party, contribute to the amount paid or payable by such indemnified party as a result of such loss, claim, damage or liability, or action in respect thereof, in such proportion as shall be appropriate to reflect the relative fault of the indemnifying party on the one hand and the indemnified party on the other with respect to the statements or omission which resulted in such loss, claim, damage or liability, or action in respect thereof, as well as any other relevant equitable considerations. The relative fault shall be determined by reference to whether the untrue or alleged untrue statement of a material fact or omission or alleged omission to state a material fact relates to information supplied by the indemnifying party on the one hand or the indemnified party on the other, the intent of the parties and their relative knowledge, access to information and opportunity to correct or prevent such statement or omission, but not by reference to an indemnified party's stock ownership in the Company. The amount paid or payable by an indemnified party as a result of the loss, claim, damage or liability, or action in respect thereof, referred to above in this paragraph shall be deemed to include, for purposes of this paragraph, any legal or other expenses reasonably incurred by such indemnified party in connection with investigating or defending any such action or claim. No person guilty of fraudulent misrepresentation (within the meaning of Section 12(f) of the Securities Act) shall be entitled to contribution from any person who was not guilty of such fraudulent misrepresentation.

#### 4. Restriction on Transfer.

(a) Shareholder covenants and agrees that in any calendar quarter he will not offer to sell, sell or otherwise dispose of any amount of

Registrable Securities in excess of one percent (1%) of the total number of shares of Common Stock then issued and outstanding.

(b) Notwithstanding the provisions of Section 4(a) of this Agreement, in the event that a Shareholder becomes liable for a payment obligation under the indemnification provisions of the Merger Agreement, Shareholder may, at his option, sell or pledge in accordance with the Registration Statement as then in effect or pursuant to an applicable exemption from registration, such number of shares of the Registrable Securities sufficient to generate net funds in the amount of that payment obligation.

5. Notices. Any notices or other communications required or permitted hereunder shall be in writing and shall be deemed duly given upon (a) confirmed delivery by a standard overnight carrier or when delivered by hand, or (b) the expiration of five business days after the day when mailed by certified or registered mail, postage prepaid, addressed at the following addresses (or at such other address as the parties hereto shall specify by like notice):

(x) If to the Company, to:

Chesapeake Utilities Corporation  
909 Silver Lake Boulevard  
Dover, Delaware 19904  
Attention: John R. Schimkaitis

with a copy to:

Covington & Burling  
1201 Pennsylvania Avenue, N.W.  
Post Office Box 7566  
Washington, D.C. 20044  
Attention: Ruth S. Epstein

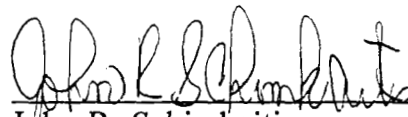
(y) If to Shareholder, to the most recent address given by Shareholder to the Company, which address initially appears below his signature.

6. Miscellaneous. This Agreement and any term hereof may be changed, waived, discharged or terminated only by an instrument in writing, signed by the party against which enforcement of such change, waiver, discharge or termination is sought or by Shareholder and the Company. This Agreement shall be construed and enforced in accordance with and governed by the laws of the State of

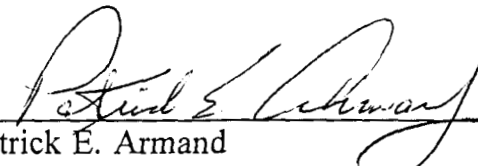
Delaware. The section headings in this Agreement are for purposes of convenience only and shall not constitute a part hereof.

IN WITNESS WHEREOF, the Company and Shareholder have caused this Agreement to be duly executed as of the date first above written.

CHESAPEAKE UTILITIES CORPORATION

By:   
John R. Schimkaitis  
President

SHAREHOLDER

  
Patrick E. Armand

Address 9119 Devoncroft  
Houston, TX 77037  
\_\_\_\_\_  
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As filed with the Securities and Exchange Commission on September 30, 1998

Registration No.: 333-64751

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**SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

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**FORM S-3  
REGISTRATION STATEMENT  
UNDER  
THE SECURITIES ACT OF 1933**

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**CHESAPEAKE UTILITIES CORPORATION**

(Exact name of Registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**51-0064146**  
(I.R.S. Employer  
Identification No.)

**909 Silver Lake Boulevard  
Dover, Delaware 19904  
(302) 734-6799**

(Address, including zip code, and telephone number,  
including area code, of Registrant's principal executive offices)

**Michael P. McMasters  
Vice President, Treasurer and  
Chief Financial Officer  
Chesapeake Utilities Corporation  
909 Silver Lake Boulevard  
Dover, Delaware, 19904  
(302) 734-6799**

(Name, address, including zip code, and telephone  
number, including area code, of agent for service)

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Approximate date of commencement of proposed sale to the public: Sales are expected to take place from time to time after this Registration Statement becomes effective.

If the only securities being registered on this Form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. ☐

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. ☒

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ☐

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ☐

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. ☐

## CALCULATION OF REGISTRATION FEE

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Title of each class of securities to be <u>registered</u>	Amount to be <u>registered</u>	Proposed maximum offering price <u>per share</u> <sup>(1)</sup>	Proposed maximum aggregate <u>offering price</u> <sup>(1)</sup>	Amount of <u>registration fee</u>
Common Stock, par value \$.4867 per share	499,999	\$ 17.84375	\$ 8,921,857	\$ 2,703.59

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<sup>(1)</sup> Estimated solely for the purpose of calculating the registration fee pursuant to Rule 457(c) based on the average of the high and low prices as reported by the New York Stock Exchange for September 28, 1998.

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The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with section 8(a) of the Securities Act of 1933 or until this Registration Statement shall become effective on such date as the Securities and Exchange Commission, acting pursuant to said section 8(a), may determine.

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## PROSPECTUS

### CHESAPEAKE UTILITIES CORPORATION

#### 499,999 Shares of Common Stock (par value \$.4867 per share)

This Prospectus relates to 499,999 presently outstanding shares (the "Shares") of Common Stock, par value \$.4867 per share (the "Common Stock"), of Chesapeake Utilities Corporation, a Delaware corporation (the "Corporation" or "Registrant"), which may be offered from time to time by shareholders of the Corporation (the "Selling Shareholders" and each individually, a "Selling Shareholder") as stated herein under the heading "Selling Shareholders".

The distribution of the Shares by the Selling Shareholders may be effected in one or more transactions through one or more of the securities exchanges, or in the over-the-counter market, in negotiated transactions or otherwise at market prices and on terms then prevailing or at prices related to the then current market price or at negotiated prices. The Corporation will not receive any of the proceeds from the sale of the Shares.

The Common Stock of Chesapeake Utilities Corporation is listed on the New York Stock Exchange ("NYSE") under the symbol "CPK". On September 28, 1998, the last trade on the NYSE for shares of the Corporation's Common Stock was consummated at a price of \$17.9375.

No dealer, salesman or other person is authorized to give any information or to make any representation in connection with the shares of Common Stock offered by this Prospectus other than those contained or incorporated by reference herein and, if given or made, any such information or representation must not be relied upon as having been authorized by Chesapeake Utilities Corporation or the Selling Shareholders. This Prospectus does not constitute an offer to sell or a solicitation of an offer to buy any securities other than those to which it relates, or an offer to sell or a solicitation of an offer to buy securities by or to any person in any jurisdiction in which it would be unlawful to make such offer or solicitation. Neither the delivery of this Prospectus nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in the affairs of Chesapeake Utilities Corporation since the date hereof.

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**THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED  
BY THE SECURITIES AND EXCHANGE COMMISSION OR ANY  
STATE SECURITIES COMMISSION NOR HAS THE SECURITIES AND  
EXCHANGE COMMISSION OR ANY STATE SECURITIES COMMISSION  
PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS.  
ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.**

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The date of this Prospectus is September 30, 1998.

## **Available Information**

Chesapeake Utilities Corporation is subject to the informational requirements of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and, in accordance therewith, files reports and other information with the Securities and Exchange Commission (the "Commission"). Such reports, proxy statements and other information concerning the Corporation may be inspected and copied at the Commission's office at Room 1024, Judiciary Plaza, 450 Fifth Street, N.W., Washington, D.C. and the Commission's Regional Offices in New York (13th Floor, Suite 1300, Seven World Trade Center, New York, New York) and Chicago (14th Floor, Suite 1400, 500 West Madison Street, Chicago, Illinois). Copies of this material also may be obtained from the Public Reference Section of the Commission at Judiciary Plaza, 450 Fifth Street, N.W., Washington, D.C. 20549 at prescribed rates. The Commission also maintains a web site (<http://www.sec.gov>) that contains reports, proxy materials and other information concerning the Corporation. Common Stock of the Corporation is listed on the New York Stock Exchange and reports, proxy material and other information concerning the Corporation also may be inspected at the offices of the NYSE, Room 401, 20 Broad Street, New York, New York 10005.

The Corporation has filed a registration statement (the "Registration Statement") with the Commission under the Securities Act of 1933 relating to the shares of Common Stock offered for sale hereby. This Prospectus has been filed as a part of the Registration Statement and does not contain all information set forth in the Registration Statement and the exhibits thereto, and reference is hereby made to such Registration Statement and exhibits for further information relating to the Corporation and the Shares. The Registration Statement and the exhibits thereto may be inspected and copied, and copies may be obtained at prescribed rates, in the manner set forth above.

## **Incorporation of Certain Documents By Reference**

The following documents, heretofore filed by the Corporation with the Commission pursuant to the Exchange Act, are incorporated by reference in this Prospectus and shall be deemed to be a part hereof:

- (a) The Corporation's Annual Report on Form 10-K for the year ended December 31, 1997;
- (b) The Corporation's Quarterly Reports on Form 10-Q for the quarters ending March 31, 1998 and June 30, 1998;
- (c) The Corporation's Current Reports on Form 8-K dated April 29, 1998, June 11, 1998 and September 1, 1998; and
- (d) The description of Common Stock contained in the Corporation's Registration Statement on Form 8-A filed pursuant to Section 12(g) of the Exchange Act, including any amendment or reports filed for the purpose of updating such description, and further described in the section "Description of Common Stock".

All reports and other documents filed pursuant to Sections 13(a), 13(c), 14 or 15(d) of the Exchange Act subsequent to the date of this Prospectus and prior to the termination of the offering of the Common Stock offered hereby shall be deemed to be incorporated by reference into this Prospectus and to be made a part hereof from their respective dates of filing. Any statement contained in an incorporated document shall be deemed to be modified or superseded for purposes of this Prospectus to the extent that a statement contained herein or in any other subsequently filed incorporated document or in any accompanying supplement to this Prospectus modifies or supersedes such statement. Any such statement so modified or

superseded shall not be deemed, except as so modified or superseded, to constitute a part of this Prospectus.

Any person to whom a copy of this Prospectus is delivered may obtain without charge, upon the written or oral request of such person, a copy of any of the documents incorporated by reference herein, except for the exhibits to such documents. Requests for copies of such documents should be directed to Office of the Secretary, Chesapeake Utilities Corporation, 909 Silver Lake Boulevard, Dover, Delaware 19904, Telephone (302) 734-6799.

## The Corporation

Chesapeake Utilities Corporation, a Delaware corporation, is a diversified utility company engaged in natural gas distribution and transmission, propane distribution and marketing, and advanced information services.

The Corporation's three natural gas divisions serve residential, commercial and industrial customers in central and southern Delaware, Maryland's Eastern Shore and Central Florida. The natural gas transmission subsidiary operates an interstate pipeline that transports gas from various points in Pennsylvania and northern Delaware to the Corporation's Delaware and Maryland distribution divisions, as well as to other utilities and industrial customers in Delaware and Maryland's Eastern Shore. The Corporation's propane segment distributes propane to customers in central and southern Delaware and the Eastern Shore of Maryland and Virginia and markets propane to large wholesale customers in the southeastern United States. The advanced information services segment provides consulting, programming and training services to a variety of clients.

The principal executive offices of the Corporation are located at 909 Silver Lake Boulevard, Dover, Delaware 19904, (telephone number 302-734-6799).

## Selling Shareholders

The Selling Shareholders are listed in the table below. The table sets forth information as of September 30, 1998.

<u>Name</u>	<u>Total Shares Presently Owned</u>	<u>Shares That May Be Sold</u>	<u>Shares That May Be Owned After Offering</u>
Earnest A. Allen, Jr. <sup>(1)</sup>	225,607	225,607	-----
Jay Phillip Keeter <sup>(1)</sup>	225,607	225,607	-----
Patrick E. Armand <sup>(1)</sup>	23,785	23,785	-----
Dashiell J. Shannahan <sup>(2)</sup>	12,745	12,745	-----
Joyce C. Shannahan <sup>(2)</sup>	12,255	12,255	-----

<sup>(1)</sup> The Shares were acquired by the Selling Shareholders on May 29, 1998 as a result of the merger of Xeron, Inc. ("Xeron") and CPK Sub-C, Inc., a wholly-owned subsidiary of the Corporation, pursuant to an agreement and plan of merger. The Selling Shareholders were officers and the sole shareholders of Xeron prior to the merger. All of the Selling Shareholders are presently employed by Xeron, pursuant to employment contracts. Mr. Allen is employed as Assistant to the President and

Mr. Keeter is employed as Energy Advisor, both pursuant to two-year employment contracts. Mr. Armand is employed as Chief Financial Officer, pursuant to a three-year employment contract. As of the commencement date of this offering, Mr. Allen, Mr. Keeter and Mr. Armand hold approximately 4.4%, 4.4%, and .5%, respectively, of the issued and outstanding Common Stock of the Corporation.

- (2) The Shares were acquired by the Selling Shareholders on March 31, 1998 as a result of the merger of Sam Shannahan Well Co., Inc. ("SSWC") and CPK Sub-B, Inc., a wholly-owned subsidiary of the Corporation, pursuant to an agreement and plan of merger. The Selling Shareholders were officers and the sole shareholders of SSWC prior to the merger. Mr. Shannahan is employed as President of SSWC, pursuant to a five-year employment contract. Ms. Shannahan serves as a consultant to the Corporation, pursuant to a five-year consulting contract. As of the commencement date of this offering, Mr. and Ms. Shannahan hold approximately .3% and .2%, respectively, of the issued and outstanding Common Stock of the Corporation.

### **Plan of Distribution**

The Shares may be offered and sold from time to time by the Selling Shareholders, or by pledgees, donees, transferees or other successors in interest. Such offers and sales may be effected by the Selling Shareholders from time to time in one or more types of transactions on one or more securities exchanges or in the over-the-counter market, in negotiated transactions or otherwise at market prices and on terms then prevailing or at prices related to the then-current market price, or at negotiated prices. Such transactions may or may not involve brokers or dealers. The Shares may be sold by one or more of the following: (a) a block trade in which a broker or dealer so engaged will attempt to sell the Shares as agent but may position and resell a portion of the block as principal to facilitate the transaction; (b) purchases by a broker or dealer as principal and resale by such broker or dealer for its account; (c) an exchange distribution in accordance with the rules of such exchange; (d) ordinary brokerage transactions and transactions in which the broker solicits purchasers; and (e) a combination of any such methods of sale. In effecting sales, brokers or dealers engaged by the Selling Shareholders may arrange for other brokers or dealers to participate. Brokers or dealers may receive commissions or discounts from the Selling Shareholders or from purchasers in amounts to be negotiated immediately prior to the sale. The Selling Shareholders and any brokers or dealers that act in connection with the sale of the Shares and any other participating brokers or dealers may be deemed to be "underwriters" within the meaning of the Securities Act in connection with such sales, and any commissions received by such brokers or dealers and any profit on the resale of the Shares sold by them while acting as principals might be deemed to be underwriting discounts or commissions under the Securities Act.

In addition, any securities covered by this Prospectus which qualify for sale pursuant to Rule 144 promulgated under the Securities Act ("Rule 144") may be sold under Rule 144 rather than pursuant to this Prospectus.

The Company and Messrs. Allen, Keeter and Armand have entered into agreements concerning indemnification and the provision of information in connection with the sale of the Shares.

Each of the Selling Shareholders has agreed that in any calendar quarter, he will not offer to sell, or otherwise dispose of any amount of the Shares in excess of one percent (1%) of the total outstanding common stock of the Corporation then issued and outstanding.

The Shares will be sold by the Selling Shareholders for their own accounts. The Corporation will not receive any of the proceeds from the sale of the Shares. All costs, expenses and fees in connection with the registration of the Shares offered hereby will be borne by the Corporation. Brokerage commissions and

similar selling expenses, if any, attributable to the sale of the Shares will be borne by the Selling Shareholders.

The Corporation has agreed with the Selling Shareholders to maintain the effectiveness of the Registration Statement (of which this Prospectus is a part) for three years from May 29, 1998, or such shorter time as may be required by Rule 144(k) under the Securities Act of 1933, as amended, or any successor provision.

The Selling Shareholders have indicated that they wish to be in a position to sell the number of Shares indicated above. The number of shares that may actually be sold by the Selling Shareholders will be determined from time to time by each Selling Shareholder, and will depend on a number of facts, including the price of the Corporation's Common Stock and the Selling Shareholder's respective personal financial circumstances from time to time. There is no assurance that any of the Selling Shareholders will offer for sale or sell any or all of his respective portion of the Shares.

### **Description of Common Stock**

The Corporation's authorized capital stock consists of 12,000,000 shares of Common Stock, par value \$.4867 per share, and 2,000,000 shares of preferred stock, par value \$0.01 per share, further described below. As of September 30, 1998, 5,076,939 shares of common stock were issued and outstanding. No shares of preferred stock are issued and outstanding.

The holders of shares of Common Stock are entitled to one vote for each share held of record on all matters submitted to a vote of stockholders and are entitled to receive dividends when and as declared by the Board of Directors out of funds legally available therefor for distribution to the holders of Common Stock and to share ratably in the assets legally available for distribution to the holders of Common Stock in the event of the liquidation or dissolution, whether voluntary or involuntary, of the Corporation. Holders of Common Stock do not have cumulative voting rights in the election of directors and have no preemptive, subscription or conversion rights. The Common Stock is not subject to redemption by the Corporation.

The preferred stock may be issued by the Corporation from time to time, by authorization of the Board of Directors and without the necessity of further action or authorization by the Corporation's stockholders, in one or more series and with such voting powers, designations, preferences and relative, participating, optional or other special rights and qualifications as the Board may, in its discretion, determine, including, but not limited to (a) the distinctive designation of such series and the number of shares to constitute such series; (b) the dividends, if any, for such series; (c) the voting power, if any, of shares of such series; (d) the terms and conditions (including price), if any, upon which shares of such stock may be converted into or exchanged for shares of stock of any other class or any other series of the same class or any other securities or assets; (e) the right, if any, of the Corporation to redeem shares of such series and the terms and conditions of such redemption; (f) the retirement or sinking fund provisions, if any, of shares of such series and the terms and provisions relative to the operation thereof; (g) the amount, if any, which the holders of the shares of such series shall be entitled to receive in case of a liquidation, dissolution, or winding up of the Corporation; (h) the limitations and restrictions, if any, upon the payment of dividends or the making of other distributions on, and upon the purchase, redemption, or other acquisition by the Corporation of, the Corporation's Common Stock; and (i) the conditions or restrictions, if any, upon the creation of indebtedness or upon the issuance of any additional stock of the Corporation.

Under the Corporation's Certificate of Incorporation, the affirmative vote of not less than 75% of the total voting power of all outstanding shares of its capital stock is required to approve a merger or consolidation of the Corporation with, or the sale of substantially all of its assets or business to, any other

corporation (other than a corporation 50% or more of the Common Stock of which is owned by the Corporation), if such corporation or its affiliates singly or in the aggregate own or control directly or indirectly 5% or more of the outstanding shares of Common Stock, unless the transaction is approved by the Board of Directors of the Corporation prior to the acquisition by such corporation or its affiliates of ownership or control of 5% or more of the outstanding shares of Common Stock. In addition, the Corporation's Certificate of Incorporation provides for a classified Board of Directors under which one-third of the members are elected annually for three-year terms. The supermajority voting requirement for certain mergers and consolidations and the classified Board of Directors may have the effect of delaying, deferring or preventing a change in control of the Corporation.

The transfer agent and registrar of the Common Stock is BankBoston N.A., c/o Boston EquiServe L.P., P.O. Box 8040, Boston, MA 02266.

#### **Legal Opinion**

The validity of the Shares of Common Stock offered hereby has been passed upon for the Corporation by Covington & Burling, Washington, D.C.

#### **Experts**

The consolidated financial statements of the Corporation as of December 31, 1997 and 1996 and for the years ended December 31, 1997, 1996 and 1995 incorporated by reference in this Registration Statement have been incorporated herein in reliance on the report of PricewaterhouseCoopers LLP, independent accountants, given on the authority of that firm as experts in accounting and auditing.

## PART II

### INFORMATION NOT REQUIRED IN THE PROSPECTUS

#### Item 14. Other Expenses of Issuance and Distribution

The estimated expenses of the Corporation in connection with the issuance and distribution of the Shares being registered hereunder are as follows. All such expenses will be borne by the Corporation.

Registration fee .....	\$ 2,704
Accounting fees and expenses .....	\$ 5,000 *
Legal fees and expenses .....	\$ 5,000 *
Miscellaneous .....	\$ 3,000
Total .....	<u>\$15,704</u>

\* Estimates.

#### Item 15. Indemnification of Directors and Officers

Under the Corporation's Bylaws, each person who was or is made a party or is threatened to be made a party to any action, suit or proceeding by reason of the fact he is or was a director or officer of the Corporation is entitled to indemnification by the Corporation to the fullest extent permitted by the Delaware General Corporation Law against all expense, liability and loss (including attorneys' fees, judgments, fines or penalties and amounts paid in settlement) reasonably incurred or suffered by such person in connection therewith, including liabilities arising under the Securities Act of 1933, as amended. These indemnification rights include the right to be paid by the Corporation the expenses incurred in defending any action, suit or proceeding in advance of its final disposition, subject to the receipt by the Corporation of an undertaking by or on behalf of such person to repay all amounts so advanced if it is ultimately determined that he is not entitled to be indemnified. These indemnification rights under the Bylaws are not exclusive of any other indemnification right which any person may have or acquire.

Section 145 of the Delaware General Corporation Law permits indemnification of a director, officer, employee or agent of a corporation who acted in good faith in a manner he reasonably believed to be in or not opposed to the best interests of the corporation and, with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful. In all proceedings other than those by or in the right of the corporation, this indemnification covers expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by the indemnified person. In actions brought by or in the right of the corporation (such as derivative actions), Section 145 provides for indemnification against expenses only and, unless a court determines otherwise, only in respect of a claim as to which the person is not judged liable to the corporation.

The Corporation has in effect liability insurance policies covering certain claims against any director or officer of the Corporation by reason of certain breaches of duty, neglect, error, misstatement, omission or other act committed by such person in his capacity as director or officer.

Article Eleven of the Corporation's Certificate of Incorporation provides that a director of the Corporation shall not be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, except for liability (i) for breach of the director's duty of loyalty to the Corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or knowing violation of law, (iii) under Section 174 of the Delaware General Corporation Law, or (iv) for any transaction from which the director derived any improper personal benefit.

Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers or persons controlling the Corporation pursuant to the foregoing provisions, the Corporation has been informed that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is therefore unenforceable.

**Item 16. Exhibits**

<u>Exhibit No.</u>	<u>Description of Exhibit</u>
5	Opinion of Covington & Burling regarding legality of the securities being offered
23.1	Consent of Covington & Burling (included in Exhibit No. 5)
23.2	Consent of PricewaterhouseCoopers LLP

**Item 17. Undertakings**

The undersigned Registrant hereby undertakes:

- (1) to file, during any period in which offers or sales are being made, a post-effective amendment to this Registration Statement;
  - (i) to include any prospectus required by Section 10(a)(3) of the Securities Act of 1933;
  - (ii) to reflect in the prospectus any facts or events arising after the effective date of the Registration Statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the Registration Statement. Notwithstanding the foregoing, any increase or decrease in volume of securities offered (if the total dollar value of securities offered would not exceed that which was registered) and any deviation from the low or high end of the estimated maximum offering range may be reflected in the form of prospectus filed with the Commission pursuant to Rule 424(b) (Section 230.424(b) of this chapter) if, in the aggregate, the changes in volume and price represent no more than a 20% change in the maximum aggregate offering price set forth in the "Calculation of Registration Fee" table in the effective registration statement; and
  - (iii) to include any material information with respect to the plan of distribution not previously disclosed in the Registration Statement or any material change to such information in the Registration Statement;

provided, however, that paragraphs (1)(i) and (1)(ii) do not apply if the Registration Statement is on Form S-3 or Form S-8, and the information required to be included in a post-effective amendment by those paragraphs is contained in periodic reports filed by the Registrant pursuant to Section 13 or Section 15(d) of the Securities Exchange Act of 1934 that are incorporated by reference in the Registration Statement;

- (2) that, for the purpose of determining any liability under the Securities Act of 1933, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof; and



(3) to remove from registration by means of a post-effective amendment any of the securities being registered which remain unsold at the termination of the offering.

The undersigned Registrant hereby undertakes that, for purposes of determining any liability under the Securities Act of 1933, each filing of the Registrant's annual report pursuant to Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934 that is incorporated by reference in this Registration Statement shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of the Registrant pursuant to the foregoing provisions, or otherwise, the Registrant has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Securities Act of 1933 and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the Registrant of expenses incurred or paid by a director, officer, or controlling person of the Registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, the Registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of such issue.

## **SIGNATURES**

Pursuant to the requirements of the Securities Act of 1933, the Registrant certifies that it has reasonable grounds to believe that it meets all of the requirements for filing on Form S-3 and has duly caused this Registration Statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Dover, State of Delaware, on the 30<sup>th</sup> day of September, 1998.

### **CHESAPEAKE UTILITIES CORPORATION**

By: /s/ RALPH J. ADKINS  
Ralph J. Adkins  
Chairman of the Board and  
Chief Executive Officer

Pursuant to the requirements of the Securities Act of 1933, this Registration Statement has been signed below by the following persons in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ RALPH J. ADKINS</u> Ralph J. Adkins	Chairman of the Board (Principal Executive Officer)	<u>September 30, 1998</u>
<u>/s/ JOHN R. SCHIMKAITIS</u> John R. Schimkaitis	President (Principal Operating Officer)	<u>September 30, 1998</u>
<u>/s/ MICHAEL P. McMASTERS</u> Michael P. McMasters	Vice President and Treasurer (Principal Financial Officer and Principal Accounting Officer)	<u>September 30, 1998</u>
<u>/s/ RICHARD BERNSTEIN</u> Richard Bernstein	Director	<u>September 30, 1998</u>
<u>/s/ WALTER J. COLEMAN</u> Walter J. Coleman	Director	<u>September 30, 1998</u>
<u>/s/ JOHN W. JARDINE, JR.</u> John W. Jardine, Jr.	Director	<u>September 30, 1998</u>
<u>  </u> Rudolph M. Peins, Jr.	Director	<u>September     , 1998</u>
<u>/s/ ROBERT F. RIDER</u> Robert F. Rider	Director	<u>September 30, 1998</u>
<u>/s/ JEREMIAH P. SHEA</u> Jeremiah P. Shea	Director	<u>September 30, 1998</u>
<u>/s/ WILLIAM G. WARDEN, III</u> William G. Warden, III	Director	<u>September 30, 1998</u>

## **OPINION OF COVINGTON & BURLING**

September 30, 1998

Chesapeake Utilities Corporation  
909 Silver Lake Boulevard  
Dover, DE 19904

Gentlemen:

This opinion is being furnished to you in connection with the Registration Statement on Form S-3 (the "Registration Statement") to be filed with the Securities and Exchange Commission (the "Commission") under the Securities Act of 1933, as amended, on the date hereof, by Chesapeake Utilities Corporation (the "Corporation"), with respect to the resale of up to 499,999 shares of Common Stock par value \$.4867 per share (the "Shares") of the Corporation by certain shareholders.

We have acted as counsel to the Corporation in connection with the preparation of the Registration Statement, and have examined signed copies of the Registration Statement. We have also examined and relied upon copies of minutes of meetings of the Board of Directors of the Corporation relating to the authorization of the shares.

We also have examined originals or copies, certified or otherwise identified to our satisfaction, of such other documents, and have made such other investigations, as we have deemed necessary to form a basis for the opinion hereinafter expressed. In making such examination, we have assumed the genuineness of all signatures, the legal capacity of all natural persons, the authenticity of all documents submitted to us as originals, and the conformity to original documents of documents submitted to us as copies. As to all matters of fact relevant to our opinion, we have relied exclusively, without independent investigation or verification, upon the foregoing documents and on the certificates of public officials and officials of the Corporation.

Based upon the foregoing, we are of the opinion that the Shares have been duly authorized and are validly issued, fully paid and nonassessable.

We hereby consent to the filing of this opinion as part of the Registration Statement and to the use of our name therein and in the related prospectus under the caption "Legal Opinion".

It is understood that this opinion is to be used only in connection with the offer and sale of the Shares as described in the Registration Statement and only while the Registration Statement is in effect.

Very truly yours,

COVINGTON & BURLING

### **CONSENT OF INDEPENDENT ACCOUNTANTS**

We consent to the incorporation by reference in this Registration Statement on Form S-3 of our report, dated February 12, 1998, on our audits of the consolidated financial statements and financial statement schedule of Chesapeake Utilities Corporation, as of December 31, 1997 and 1996 and for the years ended December 31, 1997, 1996, and 1995.

We also consent to the reference to our firm under the caption "Experts" in the Registration Statement.

PRICEWATERHOUSECOOPERS, LLP

Baltimore, Maryland  
September 30, 1998

**CHESAPEAKE**  
UTILITIES CORPORATION

April 29, 1998

Mr. Bruce H. Burcat  
Executive Director  
Delaware Public Service Commission  
861 Silver Lake Boulevard  
Suite 100  
Dover, DE 19904

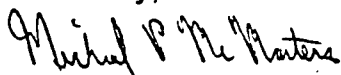
Re: **Chesapeake Utilities Corporation ("Chesapeake")**  
**Application for Approval to Issue Common Stock**

Dear Mr. Burcat:

Please find enclosed an original and nine copies of the above mentioned application for approval of the issuance of 475,000 shares of Chesapeake Utilities Corporation common stock for the purpose of acquiring all of the outstanding common stock of Xeron, Inc.

If you have any questions with respect to the above, please do not hesitate to call me at (302) 734-6798.

Sincerely,



Michael P. McMasters  
Vice President, Treasurer & CFO

cc: William A. Denman

BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF DELAWARE

IN THE MATTER OF THE APPLICATION OF  
CHESAPEAKE UTILITIES CORPORATION  
FOR APPROVAL OF THE ISSUANCE OF  
COMMON STOCK

\* P.S.C. Docket No. \_\_\_\_\_  
\*  
\*  
\* APPLICATION

Chesapeake Utilities Corporation (hereinafter sometimes called "Chesapeake")  
pursuant to 26 Del. C. section 215, makes the following application for approval by the  
Commission of the issuance of 475,000 shares of Chesapeake common stock.

1. Chesapeake is a Delaware public utility with its principal place of business  
located at 909 Silver Lake Boulevard, Dover, Delaware 19904. All communications should  
be addressed to Chesapeake at the foregoing address, attention: Michael P. McMasters,  
Vice President, Treasurer and Chief Financial Officer, or Beth W. Cooper, Assistant  
Treasurer.

2. Counsel for the applicant is William A. Denman, 414 South State Street, P.O.  
Box 497, Dover, Delaware 19903. Correspondence and other communications concerning  
this application should be directed to counsel at the foregoing address.

3. Chesapeake is a corporation incorporated under the laws of the State of  
Delaware. The voting stock of Chesapeake is publicly owned. Shares of common stock,  
4,569,576 of which were outstanding as of March 31, 1998, are the only voting securities  
of Chesapeake. Each share is entitled to one vote.

4. Xeron, Inc. is a privately-owned natural gas liquids trading company  
headquartered in Houston, Texas. Xeron markets natural gas liquids, primarily propane,

to a number of major and large independent oil and petrochemical companies, wholesale natural gas liquids resellers and southeastern retail propane companies. Subject to the terms and conditions set forth therein, by agreement and plan of merger, Chesapeake, through a subsidiary of Chesapeake formed for the purpose of effecting said transaction, CPK Sub-C, has agreed to purchase all of the outstanding common stock of Xeron, Inc. A true and correct copy of the Agreement and Plan of Merger (the "Merger Agreement") is attached hereto as Exhibit "A" and incorporated herein by reference.

5. Subject to the terms and conditions set forth in the Merger Agreement, Chesapeake proposes to issue to the shareholders of Xeron, Inc. 475,000 shares of Chesapeake common stock. Contemporaneously with the purchase of the stock of Xeron, Inc. by Chesapeake's subsidiary, CPK Sub-C, CPK Sub-C and Xeron, Inc. intend to merge, with Xeron, Inc. being the surviving entity.

6. The shares of Chesapeake common stock to be issued pursuant to the Merger Agreement will be issued as restricted securities, as defined in Rule 144 under the Securities Act of 1933. Pursuant to the Merger Agreement, Chesapeake has agreed to provide certain registration rights for these shares. A draft of the Registration Rights Agreement, setting forth the terms and conditions of these registration rights, is attached hereto as Exhibit "B". The Registration Rights Agreement will be consummated at the time of closing.

7. The issuance of Chesapeake's stock for the outstanding common stock of Xeron, Inc. is advantageous as it is a vertical integration of Chesapeake's existing propane distribution operations into the trading aspect of the business. Xeron has substantial propane supply and risk management expertise and benefits from many long-



term customer relationships. Chesapeake will benefit from improved supply capabilities, increased purchasing power and expanded marketing opportunities. The two principal shareholders have signed employment agreements and will provide their insight and expertise on an as-needed basis. The other key employees will be signing employment agreements, including the President who oversees the daily operations of Xeron.

8. The reason for the selection of the type and amount of proposed new securities is to provide for a tax free exchange for the shareholders of Xeron, Inc. and to be able to account for the acquisition under the pooling of interests method of accounting.

9. The Board of Directors of Chesapeake approved the aforesaid issuance of common stock on the 27th day of February, 1998.

10. A copy of the opinion of counsel for Chesapeake with respect to the legality of the proposed issuance of common stock is attached hereto as Exhibit "C".

11. Attached hereto as Exhibit "D" and incorporated herein by reference is a schedule setting forth Chesapeake's balance sheet and income statement for the twelve months ended December 31, 1997 both before and after the issuance of the common stock.

12. Attached hereto as Exhibit "E" is a copy of Chesapeake's annual report on Form 10-K for the calendar year ending December 31, 1997. Attached hereto as Exhibit "F" is Chesapeake's most recent quarterly report on Form 10-Q. Both reports have been filed with the Securities and Exchange Commission.

13. Pursuant to the Commission's minimum filing requirements - Part (D), attached hereto and incorporated herein by reference are the following schedules:

A. Schedule No. 1 - Capitalization ratios, actual and pro forma, as of  
December 31, 1997.

B. Schedule No. 2 - Rate of return, actual, pro forma and annualized for the twelve months ended December 31, 1997.

C. Schedule No. 3 - Fixed charge coverage ratios, historical and annualized, for the twelve months ended December 31, 1997.

14. Chesapeake represents that the proposed issuance of common stock is in accordance with law, for a proper purpose, and consistent with the public interest.

WHEREFORE, Chesapeake prays as follows:

A. That the Commission file this application and make such investigation and hold such hearings in the matter as it deems necessary;

B. That the Commission approve the proposed issuance of common stock by Chesapeake as described herein.

CHESAPEAKE UTILITIES CORPORATION

By: Michael P. McMaster  
Michael P. McMasters  
Vice President, Treasurer & CFO

SCHMITTINGER & RODRIGUEZ, P.A.

By: William A. Denman  
WILLIAM A. DENMAN, ESQUIRE  
P.O. Box 497  
Dover, DE 19903

DATED: April 29, 1998.

STATE OF DELAWARE \*

SS.

COUNTY OF KENT \*

BE IT REMEMBERED that on this 29th day of April, A.D., 1998, personally appeared before me, a Notary Public for the State of Delaware, MICHAEL P. McMASTERS, who being by me duly sworn, did depose and say that he is the Vice President, Treasurer & CFO of Chesapeake Utilities Corporation, a Delaware corporation, and that insofar as the Application of Chesapeake Utilities Corporation states facts and insofar as those facts are within his personal knowledge, they are true; and insofar as those facts are not within his personal knowledge, he believes them to be true; and that the exhibits accompanying this Application and attached hereto are true and correct copies of the originals of the aforesaid exhibits; and that he has executed this Application on behalf of the Company and pursuant to the authorization of its Board of Directors.

Michael P. McMasters

MICHAEL P. McMASTERS

Vice President, Treasurer & CFO

SWORN TO AND SUBSCRIBED before me that day and year first above written.

Lindi W. Watkins

NOTARY PUBLIC

My Commission Expires: October 21, 2001

APPLICATION OF CHESAPEAKE UTILITIES CORPORATION  
FOR APPROVAL OF THE ISSUANCE OF STOCK

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EXHIBIT A	- Agreement and Plan of Merger between Chesapeake Utilities Corporation and Xeron, Inc.
EXHIBIT B	- Draft Registration Rights Agreement between Chesapeake Utilities Corporation, J. Phillip Keeter, Earnest A. Allen, Jr. and Patrick E. Armand
EXHIBIT C	- Opinion of Legal Counsel
EXHIBIT D	- Balance Sheet and Income Statement for Chesapeake Utilities Corporation for the Twelve Months Ended December 31, 1997
EXHIBIT E	- 1997 Annual Report on Form 10-K
EXHIBIT F	- September 30, 1997 Quarterly Report on Form 10Q
SCHEDULE NO. 1	- Capitalization Ratios - Actual and Pro Forma as of December 31, 1997
SCHEDULE NO. 2	- Rate of Return - Actual, Pro Forma and Annualized for the Twelve Months Ended December 31, 1997
SCHEDULE NO. 3	- Fixed Charge Coverage Ratios - Historical and Annualized for the Twelve Months Ended December 31, 1997

MSG ID: 003386-290176

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 8-K  
CURRENT REPORT

Pursuant to Section 13 or 15(d)  
of the Securities Exchange Act of 1934

Date of Report (Date of earliest event reported): April 28, 1998

CHESAPEAKE UTILITIES CORPORATION

-----  
(Exact name of registrant as specified in its charter)

Delaware	001-11590	51-0064146
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(State of other jurisdiction of incorporation)	(Commission File Number)	(I.R.S. Employer Identification No.)

909 Silver Lake Boulevard, Dover, Delaware 19904

-----  
(Address of principal executive offices) (Zip Code)

(302) 734-6799

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(Registrant's telephone number, including area code)

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(Former name, former address and former fiscal year,  
if changed since last report.)

Item 5. Other Events

Chesapeake Utilities Corporation ("Chesapeake") has agreed to purchase all of the outstanding shares of Xeron, Inc. ("Xeron"), a privately held natural gas liquids trading company headquartered in Houston, Texas. In the transaction, the Xeron shareholders will receive 475,000 shares of Chesapeake common stock for all the outstanding common stock of Xeron. After the purchase of Xeron's stock, the total number of Chesapeake outstanding shares will be approximately 5,064,000.

The transaction, which is subject to regulatory and other required approvals and other conditions of closing, is expected to close by May 31, 1998. Attached herein as Exhibits I and II, respectively, are copies of the executed Agreement and Plan of Merger and the press release relating thereto.

SIGNATURES

Pursuant to the requirement of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned hereunto duly authorized.

CHESAPEAKE UTILITIES CORPORATION

By: /s/ RALPH J. ADKINS

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Ralph J. Adkins  
Chairman of the Board and  
Chief Executive Officer

Dated: April 29, 1998

Exhibit I.

AGREEMENT AND PLAN OF MERGER

THIS AGREEMENT AND PLAN OF MERGER (the "Agreement") is made and entered into as of April 28, 1998, by and among Chesapeake Utilities Corporation, a Delaware corporation ("Chesapeake"), CPK Sub-C, Inc., a Delaware corporation and a wholly owned subsidiary of Chesapeake ("CPK-Sub-C"), Xeron, Inc., a Mississippi corporation ("Xeron"), J. Phillip Keeter, Earnest A. Allen, Jr. and Patrick E. Armand, residents of Texas (each individually a "Shareholder," together, the "Shareholders," and with Xeron collectively, the "Sellers").

ARTICLE I  
THE MERGER

SECTION 1.1 THE MERGER. Upon the terms and subject to the conditions hereof, as promptly as practicable following the satisfaction or waiver of the conditions set forth in Article VIII hereof, but in no event later than two business days thereafter, unless the parties hereto shall otherwise agree, articles of merger (the "Articles of Merger") and a certificate of merger (the "Certificate of Merger") providing for the merger of CPK-Sub-C with and into Xeron (the "Merger") shall be duly prepared, executed and filed by Xeron, as the surviving corporation (the "Surviving Corporation"), in accordance with the relevant provisions of the Mississippi General Corporation Law (the "MGCL") and the Delaware General Corporation Law (the "DGCL") and the Merger shall become effective. Following the Merger, the Surviving Corporation shall continue under the same name as Xeron and the separate corporate existence of CPK-Sub-C shall cease. The date and time the Merger becomes effective is referred to herein as the "Effective Time." Immediately prior to the filing of the Articles of Merger and the Certificate of Merger, a closing

(the "Closing") shall take place at the offices of Xeron in Houston, Texas or at such other place and at such time as the parties shall agree.

SECTION 1.2 EFFECTS OF THE MERGER. The Merger shall have the effects set forth in Section(s) 79-4-11.01 through 79-4-11.07 of the MGCL and Sections 259, 260 and 261 of the DGCL.

SECTION 1.3 CERTIFICATE OF INCORPORATION AND BY-LAWS. The Articles of Incorporation of Xeron and the By-laws of CPK-Sub-C (both of which have been heretofore delivered by Xeron to Chesapeake or Chesapeake to Xeron, as the case may be), in each case as in effect immediately prior to the Effective Time, shall be the Articles of Incorporation and By-laws of the Surviving Corporation until duly amended in accordance with applicable law.

SECTION 1.4 DIRECTORS. The directors of CPK-Sub-C immediately prior to the Effective Time shall be the initial directors of the Surviving Corporation and shall hold office until their respective successors are duly elected and qualified in accordance with the Articles of Incorporation and By-laws of the Surviving Corporation, or their earlier death, resignation or removal.

SECTION 1.5 OFFICERS. The officers of CPK-Sub-C immediately prior to the Effective Time shall be the initial officers of the Surviving Corporation and shall serve as the officers of the Surviving Corporation at the pleasure of the Board of Directors of the Surviving Corporation.

SECTION 1.6 CONVERSION OF SHARES. At the Effective Time, by virtue of the Merger and without any action on the part of the holders thereof:

(a) Subject to Section 2.2, each issued and outstanding share of common stock, par value \$10.00 per share, of Xeron (the "Xeron Common Stock") shall automatically be converted into the right to receive (the "Stock Consideration") that number of fully paid and nonassessable shares of common stock, par value \$.4867 per share, of Chesapeake (the "Chesapeake Common Stock"), which shall be determined by dividing a total of 475,000 shares of Chesapeake Common Stock by the aggregate number of shares of Xeron Common Stock outstanding at the Effective Time, provided that in the event of a stock split or reverse stock split of the Chesapeake Common Stock prior to the Effective Time, the number of shares of Chesapeake Common Stock to be issued shall be adjusted proportionately to prevent either dilution or enlargement of the rights of the Shareholders.

(b) Each share of capital stock of Xeron that is held in the treasury of Xeron shall be canceled and retired and cease to exist and no consideration shall be issued in exchange therefor.

(c) The issued and outstanding shares of capital stock of CPK-Sub-C shall be converted into and become, in the aggregate, one thousand fully paid and nonassessable shares of common stock of the Surviving Corporation.

ARTICLE II  
EXCHANGE OF SHARES

SECTION 2.1 SURRENDER OF CERTIFICATES. At the Effective Time, each of the Shareholders shall surrender the certificate or certificates that formerly represented that Shareholder's shares of Xeron Common Stock to the Surviving Corporation, and shall thereupon receive in exchange therefor the Stock Consideration for each share of Xeron Common Stock formerly represented by such certificate or certificates, and the certificates so surrendered shall forthwith be cancelled.

SECTION 2.2 NO FRACTIONAL SHARES. No certificate or scrip representing fractional shares of Chesapeake Common Stock shall be issued upon the surrender for exchange of certificates of Xeron Common Stock, and such fractional share interests will not entitle the owner thereof to vote or to any rights of a shareholder of Chesapeake. In lieu of any such fractional share interest, Chesapeake shall pay to each shareholder of Xeron who otherwise would be entitled to receive a fractional share of Chesapeake Common Stock (after aggregating all certificates formerly representing shares of Xeron Common Stock held by the same holder) an amount of cash determined by multiplying (i) the average of the closing prices of Chesapeake Common Stock on the New York Stock Exchange ("NYSE"), as reported by The Wall Street Journal, for the twenty (20) consecutive trading days immediately preceding the second day prior to the Effective Time, by (ii) the fraction of a share of Chesapeake Common Stock to which such holder would otherwise be entitled pursuant to Section 1.6(a) of this Agreement.

ARTICLE III  
REPRESENTATIONS AND WARRANTIES  
OF THE SELLERS

Each of the Sellers represents and warrants to Chesapeake and CPK-Sub-C as follows:

SECTION 3.1 CORPORATE ORGANIZATION.

(a) Xeron is a corporation duly organized, validly existing and in good standing under the laws of the State of Mississippi and has all requisite corporate power and authority to own, lease and operate its properties and to carry on its business as now being conducted. Section 3.1(a) of the disclosure schedule to be delivered to Chesapeake prior to the date of this Agreement (the "Xeron Disclosure Schedule") sets forth the name of each jurisdiction in which Xeron is qualified or licensed to do business. Xeron is duly qualified or licensed to do business and is in good standing in each jurisdiction in which the property owned, leased or operated by it or the nature of the business conducted by it makes such qualification or licensing necessary unless failure to qualify would not result in a material adverse effect on Xeron. Xeron has heretofore delivered to Chesapeake accurate and complete copies of its Certificate of Incorporation and by-laws, as in effect as of the date of this Agreement.



(b) Xeron does not own, directly or indirectly, any capital stock or other equity securities or similar interest in any corporation, partnership, joint venture, or other business association or entity except as set forth in Section 3.1(b) of the Xeron Disclosure Schedule.

SECTION 3.2 CAPITALIZATION. The authorized capital stock of Xeron consists of 7500 shares of Xeron Common Stock, of which 6750 shares are issued and outstanding. All of the issued and outstanding shares of Xeron Common Stock are validly issued, fully paid and nonassessable. There are no subscriptions, options, warrants, calls, rights, convertible securities or other agreements or commitments of any character (whether or not currently exercisable) obligating Xeron to issue, transfer or sell any of its securities. Section 3.2 of the Xeron Disclosure Schedule sets forth (i) the name of the holder and beneficial owner of each outstanding share of Xeron Common Stock, and (ii) the number of shares of Xeron Common Stock held by such holder.

SECTION 3.3 AUTHORITY RELATIVE TO THIS AGREEMENT;  
BINDING EFFECT.

(a) Xeron has full corporate power and authority to execute and deliver this Agreement and to consummate the transactions contemplated hereby. The execution and delivery of this Agreement and the consummation of the transactions contemplated hereby have been duly and validly authorized and approved by the Board of Directors of Xeron and by the unanimous vote or written consent of the shareholders of Xeron and no other corporate proceedings on the part of Xeron are necessary to authorize this Agreement or to consummate the transactions so contemplated. This Agreement has been duly and validly executed and delivered by Xeron and constitutes a legal, valid and binding agreement of Xeron, enforceable against Xeron in accordance with its terms.

(b) This Agreement has been duly and validly executed and delivered by each Seller and constitutes a legal, valid and binding agreement of each Seller, enforceable against each Seller in accordance with its terms.

SECTION 3.4 CONSENTS AND APPROVALS; NO VIOLATIONS.

Except for the filing and recordation of the Articles of Merger, as required by the MGCL, and the Certificate of Merger, as required by the DGCL, and as set forth in Section 3.4 of the Xeron Disclosure Schedule, no filing with or notification to, and no permit, authorization, consent, waiver or approval of, any government, executive official thereof, governmental or regulatory authority, agency, commission, or court of competent jurisdiction, domestic or foreign (a "Governmental Entity"), is necessary for the consummation by the Sellers of the transactions contemplated by this Agreement. Except as set forth in Section 3.4 of Xeron Disclosure Schedule, neither the execution and delivery of this Agreement by the Sellers nor the consummation by the Sellers of the transactions contemplated hereby nor compliance by the Sellers with any of the provisions hereof will (i) conflict with or result in any breach of any provision of the Articles of Incorporation or By-laws of Xeron, (ii) result in a violation or breach of, or constitute (with or without due

notice or lapse of time or both) a default (or give rise to any right of termination, cancellation or acceleration or result in the creation of any mortgage, pledge, charge, security interest, claim or encumbrance of any kind (collectively, a "Lien")) under, any of the terms, conditions or provisions of any note, bond, mortgage, indenture, license, contract, agreement or other instrument or obligation to which any Seller is a party or by which it or any of its properties or assets may be bound, or (iii) violate any order, writ, injunction, decree, statute, rule or regulation applicable to the Sellers or any of their properties or assets.

SECTION 3.5 ABSENCE OF CERTAIN CHANGES. Except as and to the extent set forth in Section 3.5 of the Xeron Disclosure Schedule, since November 30, 1997 Xeron has not:

(a) suffered any Material Adverse Change;  
"Material Adverse Change" means (i) any material change in the nature of Xeron's business, assets, financial condition, results of operations, or prospects, (ii) the loss of a material contract (other than spot contracts which have been performed by the parties thereto in accordance with their terms), and (iii) any change that creates a material limitation on the ability of Xeron to conduct its business as heretofore conducted;

(b) paid, discharged or otherwise satisfied any material claims, liabilities or obligations (absolute, accrued, contingent or otherwise) other than the payment, discharge or satisfaction in the ordinary course of business and consistent with past practice;

(c) permitted or allowed any of its material property or assets (real, personal or mixed, tangible or intangible) to be subjected to any Liens, except for (i) Liens for current taxes or other governmental charges not yet due and payable, or the amount or validity of which is being contested by the appropriate proceedings and for which an appropriate reserve has been established and is reflected in the Financial Statements (as defined below), (ii) Liens disclosed in Sections 3.23(b) and 3.23(c) of the Xeron Disclosure Schedule, (iii) Liens of carriers, warehousemen and mechanics and similar Liens incurred in the ordinary course of business, and (iv) zoning, entitlement and other land use regulations (collectively, "Permitted Liens");

(d) sold, transferred, or otherwise disposed of any of its properties or assets (real, personal or mixed, tangible or intangible), except in the ordinary course of business and consistent with past practice;

(e) granted any increase in the compensation or benefits of any director, officer or employee (including any such increase pursuant to any bonus, pension, profit sharing or other plan or commitment) or any increase in the compensation or benefits payable or to become payable to any director, officer or employee, and no such increase is customary on a periodic basis or required by agreement or understanding;

(f) made any change in Xeron's severance

policy or practices;

(g) made any expenditure capitalized in accordance with generally accepted accounting principles or acquired any property or assets for a cost in excess of \$25,000, in the aggregate, other than in the ordinary course of business;

(h) declared, paid or set aside for payment any dividend or other distribution in respect of its capital stock or redeemed, purchased or otherwise acquired, directly or indirectly, any shares of capital stock or other securities of Xeron;

(i) made any change in any method of tax or financial accounting or accounting practice or made or changed any election for Federal income tax purposes;

(j) paid, loaned or advanced any amount to, or sold, transferred or leased any properties or assets (real, personal or mixed, tangible or intangible) to, or entered into any agreement or arrangement with, any of its officers, directors or shareholders or any affiliate or associate of any of its officers, directors or shareholders except for directors' fees, and compensation to officers at rates not exceeding the rates of compensation paid during the six month period immediately prior to November 30, 1997;

(k) agreed or planned, whether in writing or otherwise, to take any action described in this Section.

SECTION 3.6 FINANCIAL STATEMENTS. Xeron shall have furnished to Chesapeake prior to the date of this Agreement audited balance sheets for the last two completed fiscal years, audited statements of income, equity and cash flows of Xeron for the last three completed fiscal years and an unaudited balance sheet and statement of income for the nine month period ending February 28, 1998 (collectively, the "Financial Statements"). The audited financial statements are true, correct and complete in all material respects, fairly present, in conformity with generally accepted accounting principles applied on a consistent basis (except as may be indicated in Section 3.6 of the Xeron Disclosure Schedule) the financial position of Xeron as of the dates thereof and its consolidated results of operations and changes in financial position and changes in stockholders equity and cash flows for the periods then ended. Such unaudited balance sheet and statement of income shall be certified by the Chief Executive Officer of Xeron as having been prepared under his supervision; as presenting the financial position of Xeron in accordance with generally accepted accounting principles consistently applied (except as may be indicated in Section 3.6 of the Xeron Disclosure Schedule); to be true, correct and complete in all material respects; and to reflect accurately the results of operations of Xeron for such nine month period.

SECTION 3.7 NO UNDISCLOSED LIABILITIES. Except as and to the extent provided in the Financial Statements or Section 3.7 of the Xeron Disclosure Schedule, Xeron does not have any material liabilities (whether contingent or absolute, direct or indirect, known or unknown to Xeron or matured or

unmatured) not fully reflected or fully reserved against in the Financial Statements. Except as set forth in Section 3.7 of the Xeron Disclosure Schedule, since November 30, 1997, Xeron has not incurred any liability except in the ordinary course of business consistent with past practice.

SECTION 3.8 NO DEFAULT. Except as set forth in Section 3.8 of the Xeron Disclosure Schedule, Xeron is not in default or violation (and no event has occurred that with notice or the lapse of time or both would constitute a default or violation) of any term, condition or provision of (i) its Certificate of Incorporation or its By-laws, (ii) any note, bond, mortgage, indenture, license, contract, agreement or other instrument or obligation to which Xeron is a party or by which it or any of its properties or assets are bound, or (iii) any order, writ, injunction, decree, statute, rule or regulation applicable to Xeron or any of its properties or assets, unless any such default or violation would not have a material adverse effect on Xeron.

SECTION 3.9 LITIGATION. Except as set forth in Section 3.9 of the Xeron Disclosure Schedule, there is no action, suit, proceeding, arbitration, or investigation pending or, to the knowledge of Xeron, threatened involving Xeron or any of its properties or assets. Neither Xeron nor any of its properties or assets is subject to any order, writ, judgment, injunction, decree, determination or award. There is no action, suit, proceeding, arbitration or investigation initiated by Xeron that is currently pending or that Xeron presently intends to initiate.

#### SECTION 3.10 COMPLIANCE WITH APPLICABLE LAW.

Except as set forth in Section 3.10 of the Xeron Disclosure Schedule, the business of Xeron has not been conducted in violation of any applicable law, ordinance, rule, regulation, decree or order of any Governmental Entity, unless such violation will not result in a material adverse effect on Xeron. Xeron holds all permits, licenses, variances, exemptions, orders and approvals of all Governmental Entities necessary for the lawful conduct of its businesses (the "Xeron Permits") and is in compliance with the terms of the Xeron Permits, unless the failure to obtain any Xeron Permits or be in compliance therewith will not result in a material adverse effect on Xeron. Except as set forth in Section 3.10 of the Xeron Disclosure Schedule, Xeron has not received any notification of any asserted present or past failure by Xeron to comply with such laws, rules or regulations or such Xeron Permits which have not been previously cured, and there is, to the knowledge of Xeron, no pending audit, investigation or other review by any Governmental Entity to determine the existence of any violation of such laws, rules or regulations or such Xeron Permits.

#### SECTION 3.11 TAXES.

(a) Since June 1, 1979, Xeron has been a C corporation for purposes of the Internal Revenue Code of 1986, as amended, and the rules and regulations promulgated thereunder (the "Code").

(b) The amounts, if any, provided as a

liability on the Financial Statements for all Taxes (as hereinafter defined) ("tax liability amounts") are adequate to cover all unpaid liabilities for all Taxes, whether or not disputed, that have accrued or will accrue with respect to or are applicable to the period ended on and including the Effective Time (including, without limitation, as a result of the transactions contemplated by this Agreement) or to any years and periods prior thereto and for which Xeron may be directly or contingently liable in its own right or as a transferee of the assets of, or successor to, any person; provided, however, that with respect to tax liability amounts reflected on the unaudited financial statements for the nine-month period ending February 28, 1998, the term "adequate" means that such amounts are reasonable estimates made in good faith based on currently available information. Except as set forth in Section 3.11(b) of the Xeron Disclosure Schedule, Xeron has incurred no Tax liabilities other than in the ordinary course of business for any taxable year for which the applicable statute of limitations has not expired. There are no Liens for Taxes (other than Liens for current Taxes not yet due and payable, or the amount or validity of which is being contested by the appropriate proceedings and for which an appropriate reserve has been established and is reflected in the Financial Statements) upon the properties or assets of Xeron. Xeron has not granted or been requested to grant any waiver of any statutes of limitations applicable to any claim for Taxes. Xeron has made no elections for federal income tax purposes, except for customary elections for inventory, amortization and depreciation.

(c) Xeron (i) has filed (or has had filed on its behalf) or has caused to be filed timely all Tax Returns (as hereinafter defined) required by applicable law to be filed and (ii) has paid all Taxes shown thereon as owing. To the knowledge of Xeron, each such Tax Return is true, accurate and complete and Xeron has paid all Taxes as are due, except such as are being contested in good faith by appropriate proceedings and with respect to which Xeron is maintaining reserves adequate for their payment. All Taxes that Xeron is required by law to withhold or collect, including sales and use taxes, and amounts required to be withheld for Taxes of employees and other withholding taxes, have been duly withheld or collected and, to the extent required, have been paid over in a timely manner to the proper governmental authorities or are held in separate bank accounts for such purpose.

(d) No extensions of time have been granted for Xeron to file any Tax Return required by applicable law to be filed, which have expired, without such Tax Return having been filed.

(e) Except as disclosed in Section 3.11(e) of the Xeron Disclosure Schedule, none of the Tax Returns filed by or on behalf of Xeron are currently undergoing any Audit (as hereinafter defined), Xeron has received no notice that any Tax Return will undergo any Audit, and no facts exist that would constitute grounds for the assessment against Xeron of any material additional Taxes by any governmental authority for periods that have not been audited. No material issues have been raised in any Audit by any governmental authority with respect to the business and operations of Xeron that, by

application of similar principles, reasonably could be expected to result in a proposed adjustment to the liability for Taxes for any other period not so examined. No deficiency or adjustment for any Taxes has been threatened, proposed, asserted, or assessed against Xeron.

(f) No power of attorney has been granted by Xeron with respect to any matter relating to Taxes which is currently in force.

(g) Xeron is not a party to any agreement providing for the allocation or sharing of Taxes.

(h) Xeron has not entered into any agreement that would result in the disallowance of any tax deduction pursuant to Code Section 280G.

(i) No "consent" within the meaning of Code Section 341(f) has been filed with respect to Xeron.

(j) Except as disclosed in Section 3.11(j) of the Xeron Disclosure Schedule, Xeron is not subject to any arrangement that (a) gives rise to a deduction or loss before the Effective Time and a corresponding recognition of taxable gain or income after the Effective Time or (b) gives rise to the recognition of taxable income or gain after the Effective Time without the receipt of a corresponding amount of cash.

(k) None of the Shareholders is a "foreign person" as defined in Code Section 1445(f)(3).

(l) None of the assets of Xeron constitutes tax-exempt bond financed property or tax-exempt use property within the meaning of Code Section 168, and none of the assets reflected on the Financial Statements is subject to a lease, safe harbor lease or other arrangement as a result of which Xeron is not treated as the owner of such assets for federal income tax purposes.

(m) The basis of all depreciable or amortizable assets, and the methods used in determining allowable depreciation or amortization (including cost recovery) deductions of Xeron, are materially correct and in compliance with the Code.

(n) To the knowledge of Xeron, Xeron is not required to make any material adjustment under Code Section 481(a) by reason of a change or proposed change in accounting method or otherwise.

(o) For purposes of this Section:

(i) the term "Taxes" shall mean all taxes, charges, fees, duties (including customs duties), levies or other assessments, including income, gross receipts, net proceeds, ad valorem, turnover, real and personal property (tangible and intangible), sales, use, franchise, excise, value added, stamp, leasing, lease, user, transfer, fuel, excess profits, occupational, interest equalization, windfall profits, severance, license, payroll, environmental, capital stock,

disability, employee's income withholding, other withholding, unemployment and Social Security taxes, which are imposed by any federal, state, local or foreign governmental authority, and such term shall include any interest, penalties or additions to tax attributable thereto;

(ii) the term "Tax Return" shall include all federal, state, local and foreign tax returns, declarations, statements, reports, schedules, forms and information returns and any amended Tax Return relating to Taxes; and

(iii) the term "Audit" shall include any taxing authority's audit, assessment of Taxes, or other examination proceedings or appeal of such proceedings relating to Taxes.

#### SECTION 3.12 BENEFIT PLANS AND ARRANGEMENTS

(a) Section 3.12(a) of the Xeron Disclosure Schedule contains a list of all employee benefits, plans or arrangements (whether or not subject to the Employee Retirement Income Security Act of 1974, as amended, and the rules and regulations promulgated thereunder ("ERISA"), and whether written or oral) that Xeron has maintained or to which it has contributed at any time for the benefit of its employees (the "Employee Benefit Plans").

(b) Xeron has provided Chesapeake with a true and complete copy of each of the following for the Employee Benefit Plans which are currently in effect: the current plan document, including any amendments thereto, the most recent summary plan description, annual reports on form 5500 for the three most recent years (if such forms were required to be filed), and any trust agreements, insurance contracts, service provider agreements or similar agreements. Xeron has no plan or commitment, whether legally binding or not, to create any additional benefit plans or arrangements or to change the terms of the Employee Benefits Plans.

(c) Xeron has complied in all material respects with all applicable provisions of ERISA and the Code and all other applicable laws, rules, and regulations with respect to the Employee Benefit Plans except for compliance failure(s) that individually or in the aggregate would not have a material adverse effect on Xeron. The Employee Benefit Plans are not subject to any ongoing audit or other administrative proceeding of any governmental entity, and are not the subject of any pending application for administrative relief under any program of the IRS, the Department of Labor, or any other governmental entity. Xeron has disclosed in Section 3.12(c) of the Xeron Disclosure Schedule all material liabilities with respect to the Employee Benefit Plans to Chesapeake. There are no pending or threatened claims (other than routine claims for benefits) against the Employee Benefit Plans by any person. The Employee Benefit Plans are not multiemployer plans within the meaning of ERISA except as set forth in Section 3.12(c) of the Xeron Disclosure Schedule. The Employee Benefit Plans can be terminated, without penalty, with no requirement for the further provision of benefits,

within a period of 30 days. None of the representations in this Section will be affected by the occurrence of the Merger.

### SECTION 3.13 ENVIRONMENTAL MATTERS.

(a) Except as set forth in Section 3.13 of the Xeron Disclosure Schedule, neither Xeron nor any Shareholder has learned, been advised, or received any communication (written or oral), whether from a governmental authority, citizens group, employee or otherwise that alleges or suggests that Xeron or any Shareholder is not in full compliance with the Environmental Laws. Section 3.13 of the Xeron Disclosure Schedule lists the permits or other governmental authorizations that Xeron has pursuant to the Environmental Laws.

(b) To the knowledge of Xeron, there are no Environmental Claims (as hereinafter defined) pending or threatened against Xeron or any Shareholder or against any person or entity whose liability for any Environmental Claim Xeron or any Shareholder has retained, or has assumed either contractually or by operation of law and neither Xeron nor any Shareholder knows of any facts or allegations that could result in future Environmental Claims.

(c) To the knowledge of Xeron, none of the Real Property, as such term is defined in Section 3.23, nor any property owned or leased by Xeron is on the National Priorities List or the Comprehensive Environmental Response Compensation and Liability Information System, and no such property is a Resource Conservation and Recovery Act "permitted facility." No such property is permitted by the state in which it is located to be used as a landfill or disposal site of any type.

(d) To the knowledge of Xeron, Section 3.13 of the Xeron Disclosure Schedule lists all tanks that have been owned, leased, operated or used by Xeron, or which are currently used by Xeron and are located on the Real Property, as such term is defined in Section 3.23.

(e) For purposes of this Agreement:

(i) "Environmental Claim" means any claim, action, cause of action, litigation, proceeding, order, decree, investigation or notice (written or oral) by any person or entity alleging potential liability or responsibility (including, without limitation, potential liability or responsibility for investigatory costs, cleanup costs, costs of compliance with laws, requirements, guidelines, or orders, governmental response costs, natural resources damages, property damages, personal injuries, or penalties) arising out of, based on or resulting from (a) the presence, or release into the environment, of any Materials of Environmental Concern at any location, whether or not owned or operated by Xeron or (b) circumstances forming the basis of any violation, or alleged violation, of any Environmental Laws.

(ii) "Environmental Laws" means all Federal, state, local and foreign laws, regulations, ordinances,



rules, guidelines, orders, directives, judgments and determinations relating in any way to pollution or protection of human health or the environment (including, without limitation, ambient air, surface water, ground water, land surface or subsurface strata), including, without limitation, laws and regulations relating to emissions, discharges, releases or threatened releases of Materials of Environmental Concern, or otherwise relating to the manufacture, processing, distribution, use, treatment, storage, disposal, transport or handling of Materials of Environmental Concern, as amended from time to time.

(iii) "Materials of Environmental Concern" means chemicals, pollutants, contaminants, hazardous materials, hazardous substances, hazardous wastes, toxic substances, petroleum and petroleum products, and any substance controlled or regulated by any Environmental Law.

SECTION 3.14 CHANGE IN CONTROL. Except as set forth in Section 3.14 of the Xeron Disclosure Schedule, Xeron is not a party to any contract, agreement or understanding which contains a "change in control," "potential change in control" or similar provision. Except as set forth in Section 3.14 of the Xeron Disclosure Schedule, the consummation of the transactions contemplated by this Agreement will not (either alone or upon the occurrence of any additional acts or events) result in any payment (whether of severance pay or otherwise) becoming due from Xeron to any person.

#### SECTION 3.15 INTELLECTUAL PROPERTY.

(a) Except as set forth in Section 3.15(a) of the Xeron Disclosure Schedule, Xeron owns, or is licensed or otherwise has the full right to use, all copyrights, trademarks and service marks (including all applications and registrations therefor), trade names, computer software, patents (including applications therefor), and all other intellectual property that is necessary for the conduct of its business as heretofore conducted (collectively, the "Intellectual Property"). Xeron has not sold or conveyed to any third-party the right to use proprietary software developed by or for Xeron.

(b) Except as set forth in Section 3.15(b) of the Xeron Disclosure Schedule, there are no outstanding claims, judgments, settlements or proceedings against Xeron asserting the invalidity, abuse, misuse or unenforceability of any of the Intellectual Property and there are no threatened claims or proceedings relating to the validity of or enforceability of the Intellectual Property. There are no pending or threatened opposition or other administrative proceedings with respect to any Intellectual Property which is the subject of a pending application that would prevent the registration in due course of such Intellectual Property.

SECTION 3.16 CONTRACTS AND COMMITMENTS. Except as set forth in Section 3.16 of the Xeron Disclosure Schedule:

(a) Xeron has no agreements, contracts,

commitments, or restrictions that are material to its business, prospects, financial condition, working capital, assets, liabilities (absolute, accrued, contingent or otherwise) or operations;

(b) There are no purchase contracts or commitments under which Xeron is required to pay in excess of \$300,000, other than those incurred in the ordinary course of business;

(c) There are no outstanding sales contracts or commitments of Xeron that call for the payment to, or receipt by, Xeron of more than \$300,000, other than those incurred in the ordinary course of business;

(d) Xeron has no outstanding contracts with officers, directors or employees that are not cancelable by it on notice of not longer than thirty (30) days and without liability, penalty, or premium or any agreement or arrangement providing for the payment of any bonus or commissions based on sales or earnings;

(e) Xeron is not in default, nor aware of any facts or circumstances which could serve as the basis for any valid claim of default, under any material contract made or obligation owed by it;

(f) Xeron is not restricted by agreement from carrying on its business anywhere in the world;

(g) Xeron has no obligation with respect to borrowed money (except for a line of credit from Norwest Bank in the maximum amount of \$5,000,000), including debt obligations of its own or guarantees of or agreements to acquire any debt obligation of others;

(h) Xeron has no power of attorney outstanding or any obligations or liabilities (whether absolute, accrued, contingent, or otherwise), as guarantor, surety, co-signer, endorser, co-maker or indemnitor for the obligation of any person, corporation, partnership, joint venture, association, organization, or other entity; and

(i) None of the officers, directors or shareholders of Xeron has any interest in any property, real or personal, tangible or intangible, including without limitation Intellectual Property, that is used in the business of Xeron.

SECTION 3.17 LABOR RELATIONS. As of the date hereof, there is no strike or other labor dispute pending against Xeron. Xeron is not bound by or subject to (and none of its properties or assets is bound by or subject to) any written or oral, express or implied, contract, commitment or arrangement with any labor union, and no labor union has requested or sought to represent any of the employees, representatives or agents of Xeron, nor is Xeron aware of any labor organization activity involving its employees. Except as previously disclosed in writing to Chesapeake, no officer or employee of Xeron has any plans to terminate his employment with Xeron.

SECTION 3.18 EMPLOYEE BENEFIT PLANS. Except as disclosed in Section 3.18 of the Xeron Disclosure Schedule, Xeron has previously given to Chesapeake true and correct copies of its work rule manuals, rules, policies or other guidelines relating to employee compensation, retirement and severance and each employment or consulting contract to the extent they exist. Except as set forth in Section 3.18 of the Xeron Disclosure Schedule and except as previously disclosed to Chesapeake in writing, there are no other significant employee benefit plans, programs or arrangements, maintained or contributed to by Xeron.

SECTION 3.19 PERSONNEL. Xeron has furnished to Chesapeake a list of the names and current salaries of each officer and employee of Xeron as of the date of this Agreement. Section 3.19 of the Xeron Disclosure Schedule sets forth a complete and correct list of all written employment, compensation, severance, consulting or indemnification contracts between Xeron and its present or former employees, officers, directors and consultants to the extent Xeron has any continuing obligations thereunder. Xeron has made available to Chesapeake true and correct copies of all such agreements.

SECTION 3.20 INSURANCE. Section 3.20(a) of the Xeron Disclosure Schedule contains an accurate and complete list of all policies of fire, liability, workmen's compensation and other forms of insurance owned or held by Xeron, except with respect to the policies as disclosed in Section 3.12 of the Xeron Disclosure Schedule. In the reasonable judgment of the Sellers, such policies are in adequate amounts and cover risks customarily insured against by businesses of the type operated by Xeron. Except as set forth in Section 3.20(a) of the Xeron Disclosure Schedule, all such policies are in full force and effect, all premiums with respect thereto covering all periods up to and including the Effective Time will have been paid, and no notice of cancellation of termination has been received with respect to any such policy. Except as set forth in Section 3.20(a) of the Xeron Disclosure Schedule, such policies will remain in full force and effect through the respective dates set forth in Section 3.20(a) of the Xeron Disclosure Schedule without the payment of additional premiums, and will not be materially affected by, or terminate or lapse by reason of, the transactions contemplated by this Agreement. All of such policies have been issued by reputable insurance companies actively engaged in the insurance business. All known claims, if any, made against Xeron that are covered by insurance have been disclosed to and accepted by the appropriate insurance companies and, to the knowledge of Xeron, are being defended by such appropriate insurance companies and are described in Section 3.20(b) of the Xeron Disclosure Schedule, and, except as disclosed in Section 3.20(b) of the Xeron Disclosure Schedule, no claims have been denied coverage during the last three years.

SECTION 3.21 RECEIVABLES. All accounts and notes due and uncollected as reflected on the Financial Statements, and all accounts and notes due and uncollected arising subsequent to February 28, 1998 (i) have arisen in the ordinary course of business of Xeron, except as set forth in

Section 3.21 of the Xeron Disclosure Schedule, and (ii) represent valid obligations due to Xeron enforceable in accordance with their terms, net of applicable reserves. Xeron has previously made available to Chesapeake lists of the aging and amounts of all accounts and notes due and uncollected at February 28, 1998. No reserve for bad debts is required as of February 28, 1998.

SECTION 3.22 RELATED PARTY CONTRACTS. Except as set forth in Section 3.22 of the Xeron Disclosure Schedule, Xeron has no agreements, arrangements or commitments with related parties (including shareholders, directors and officers), other than the related-party agreements described in Sections 3.16(d) and 3.16(i) of the Xeron Disclosure Schedule. Except as set forth in Section 3.22 of the Xeron Disclosure Schedule, each of the related-party agreements was entered into between Xeron and the party thereto on an arm's length basis on terms no less favorable to Xeron than it could obtain from an unrelated third party.

SECTION 3.23 REAL PROPERTY; LEASED PREMISES.

(a) Section 3.23(a) of the Xeron Disclosure Schedule sets forth a true and complete list and description of all real property and land owned by Xeron and the buildings, improvements and structures located thereon, except for the Leased Premises (as defined below) (collectively, the "Real Property"). Each of the material improvements located upon the Real Property owned or used by Xeron (including, without limitation, all buildings, land and equipment leased by Xeron) is in reasonably good repair and operating condition.

(b) Xeron has good and valid title to the Real Property in fee simple and to the structures and fixtures attached or appurtenant to or used in connection with the Real Property, free and clear of all Liens, except (i) as set forth in Section 3.23(b) of the Xeron Disclosure Schedule, and (ii) Permitted Liens.

(c) Section 3.23(c) of the Xeron Disclosure Schedule sets forth a true and complete list of each lease of premises executed by or binding upon Xeron as lessee, sublessee, tenant or assignee (the "Leased Premises"). Except as set forth in Section 3.23(c) of the Xeron Disclosure Schedule, each such lease is in full force and effect without any default or breach thereof by Xeron or, to the knowledge of Xeron, by any other party thereto. True and complete copies of all leases listed on Schedule 3.23(c) of the Xeron Disclosure Schedule (including all amendments, addenda, waivers and all other binding documents relating thereto) have been made available to Chesapeake.

(d) Except as set forth in Section 3.23(d) of the Xeron Disclosure Schedule, Xeron has not received any notice of or writing referring to any requirements by any insurance company that has issued a policy covering any part of any Real Property or Leased Premises or by any board of fire underwriters or other body exercising similar functions, requiring any repairs or work to be done on any part of any Real Property or Leased Premises.

SECTION 3.24 ABSENCE OF CERTAIN PAYMENTS. Neither Xeron nor any of its affiliates or any of their respective officers, directors, employees or agents or other people acting on behalf of Xeron have (i) engaged in any activity prohibited by the United States Foreign Corrupt Practices Act of 1977 or any other similar law, regulation, decree, directive or order of any other country and (ii) without limiting the generality of the preceding clause (i), used any corporate or other funds for unlawful contributions, payments, gifts or entertainment; or made any unlawful expenditures relating to political activity to government officials or others. None of Xeron or any of its affiliates or any of their respective directors, officers, employees or agents of other persons acting on behalf of Xeron, has accepted or received any unlawful contributions, payments, gifts or expenditures.

SECTION 3.25 DISCLOSURE. No representation or warranty by Xeron or the Sellers in this Agreement and no statement in any document, schedule or certificate furnished or to be furnished by the Sellers to Chesapeake or any of its representatives pursuant to the provisions hereof or in connection with the transactions contemplated hereby, contains any untrue statement of material fact or omits or will omit to state any material fact necessary in order to make the statements herein or therein, in light of the circumstance under which they were made, not misleading.

SECTION 3.26 PUHCA.

(a) Xeron is not a "public-utility company," as that term is defined in Section 2(a)(5) of the Public Utility Holding Company Act of 1935, and the rules and regulations thereunder (the "1935 Act").

(b) Upon consummation of the Merger, none of the Shareholders, individually or in the aggregate, shall constitute a "holding company" with respect to Chesapeake, as that term is defined in Section 2(a)(7) of the 1935 Act.

(c) None of the Sellers, individually or in the aggregate, directly or indirectly owns, controls or holds with power to vote five percent or more of the outstanding voting securities of a public-utility company, as that term is defined in Section 2(a)(5) of the 1935 Act.

SECTION 3.27 POOLING MATTERS. The representations, warranties and covenants of Xeron set forth in the form of letter from Xeron to Coopers & Lybrand, attached hereto as Annex A-1, are true and correct in all material respects (except as such matters may be subject to the control of Chesapeake or its affiliates).

SECTION 3.28 YEAR 2000. Except as set forth in Section 3.28 of the Xeron Disclosure Schedule, Xeron does not rely on any computer or information systems or equipment that will not operate or perform properly using dates for January 1, 2000 and beyond.

SECTION 3.29 KNOWLEDGE. The phrase "to the knowledge of Xeron" means to the knowledge of Xeron or any of

its officers.

#### ARTICLE IV REPRESENTATIONS AND WARRANTIES OF CHESAPEAKE

Chesapeake represents and warrants to the Sellers as follows:

SECTION 4.1 CORPORATE ORGANIZATION. Each of Chesapeake and CPK-Sub-C is a corporation duly organized, validly existing and in good standing under the laws of the jurisdiction of its incorporation and has all requisite corporate power and authority to own, lease and operate its properties and to carry on its business as now being conducted. The Certificate of Incorporation and By-laws of Chesapeake, as currently in effect, are filed as exhibits to Chesapeake's Annual Report on Form 10-K. Chesapeake has heretofore delivered to the Sellers accurate and complete copies of the Certificate of Incorporation and By-laws, as currently in effect, of Chesapeake.

SECTION 4.2 CAPITALIZATION. As of the date of this Agreement, the authorized capital stock of Chesapeake consists of 12,000,000 shares of Chesapeake Common Stock and 2,000,000 shares of preferred stock, of which 4,577,778 shares of Chesapeake Common Stock are issued and outstanding. All of such issued and outstanding shares of Chesapeake Common Stock are validly issued, fully paid and nonassessable and free of preemptive rights. As of the date of this Agreement, (i) 163,637 shares of Chesapeake Common Stock were issuable upon exercise of warrants or stock options; 26,700 shares of Chesapeake Common Stock were issuable in accordance with Chesapeake's Long Term Incentive Awards Plan; and 173,771 shares of Chesapeake Common Stock were reserved for issuance under such plans and (ii) there are \$3,852,000 face amount convertible debt securities outstanding that are convertible into 226,455 shares of Chesapeake Common Stock. Except as set forth above and in the Chesapeake financial statements and other public filings, or as may be required in connection with Chesapeake's ongoing acquisition activities, there are not any shares of capital stock (or securities substantially equivalent to capital stock) of Chesapeake issued or outstanding or any subscriptions, options, warrants, calls, rights, convertible securities or other agreements or commitments of any character obliging Chesapeake to issue, transfer or sell any of its securities.

SECTION 4.3 AUTHORITY RELATIVE TO THIS AGREEMENT. Each of Chesapeake and CPK-Sub-C has full corporate power and authority to execute and deliver this Agreement and to consummate the transactions contemplated hereby. The execution and delivery of this Agreement and the consummation of the transactions contemplated hereby have been duly and validly authorized and approved by the Boards of Directors of Chesapeake and CPK-Sub-C and by Chesapeake as the sole shareholder of CPK-Sub-C and no other corporate proceedings on the part of Chesapeake or CPK-Sub-C are necessary to authorize this Agreement or to consummate the transactions so contemplated. This Agreement has been duly and validly executed and delivered by each of Chesapeake and CPK-Sub-C and

constitutes a valid and binding agreement of each of Chesapeake and CPK-Sub-C, enforceable against each of Chesapeake and CPK-Sub-C in accordance with its terms.

#### SECTION 4.4 CONSENTS AND APPROVALS; NO VIOLATIONS.

Except for the filing and recordation of the Articles of Merger, as required by the MGCL, and the Certificate of Merger, as required by the DGCL, the filing with the Delaware Public Utilities Commission, and as set forth in Section 4.4 of the disclosure schedule to be delivered to the Sellers prior to the date of this Agreement (the "Chesapeake Disclosure Schedule"), no filing with or notification to, and no permit, authorization, consent, waiver or approval of, any Governmental Entity, is necessary for the consummation by Chesapeake of the transactions contemplated by this Agreement. Except as set forth in Section 4.4 of the Chesapeake Disclosure Schedule, neither the execution and delivery of this Agreement by Chesapeake or CPK-Sub-C nor the consummation by Chesapeake and CPK-Sub-C of the transactions contemplated hereby nor compliance by Chesapeake or CPK-Sub-C with any of the provisions hereof will (i) conflict with or result in any breach of any provision of the Certificate of Incorporation or By-laws of Chesapeake or any of its subsidiaries, (ii) result in a violation or breach of, or constitute (with or without due notice or lapse of time or both) a default (or give rise to any right of termination, cancellation or acceleration or result in the creation of any Lien) under, any of the terms, conditions or provisions of any note, bond, mortgage, indenture, license, contract, agreement or other instrument or obligation to which Chesapeake or any of its subsidiaries is a party or by which any of them or any of their respective properties or assets may be bound or (iii) violate any order, writ, injunction, decree, statute, treaty, rule or regulation applicable to Chesapeake, any of its subsidiaries or any of their properties or assets.

SECTION 4.5 SEC REPORTS. Chesapeake has filed on a timely basis all required forms, reports and documents with the Securities and Exchange Commission ("SEC") since January 1, 1994 (collectively, the "Chesapeake SEC Reports"), each of which has complied in all material respects with all applicable requirements of the Securities Act of 1933 (the "Securities Act"), and the Securities Exchange Act of 1934 (the "Exchange Act"), and the rules and regulations of the SEC, as each was in effect on the dates so filed. Chesapeake has heretofore delivered to Xeron and the Sellers in the form filed with the SEC, its (i) Annual Reports on Form 10-K for each of the last three fiscal years and (ii) all definitive proxy statements relating to Chesapeake meetings of shareholders (whether annual or special) held since January 1, 1994. The audited consolidated financial statements and unaudited consolidated interim financial statements of Chesapeake included in the Chesapeake SEC Reports are true, correct and complete in all material respects; fairly present, in conformity with generally accepted accounting principles applied on a consistent basis (except as may be indicated in the notes thereto), the consolidated financial position of Chesapeake and its consolidated subsidiaries as of the dates thereof and their consolidated results of operations and changes in financial position and changes in stockholders equity and cash flows for the periods then ended (subject to

normal year-end and audit adjustments in the case of any unaudited interim financial statements).

SECTION 4.6 CPK-SUB-C. CPK-Sub-C has not conducted any operations or incurred any liabilities or obligations other than arising under or in connection with its formation and the transactions contemplated by this Agreement.

SECTION 4.7 CHESAPEAKE SHARES. All of the shares of Chesapeake Common Stock to be issued in connection with the Merger will, at the time of such issuance, be validly issued, fully paid and nonassessable and free of preemptive rights and free of any adverse liens, claims, charges or encumbrances.

SECTION 4.8 DISCLOSURE. No representation or warranty by Chesapeake in this Agreement and no statement contained in any document (including without limitation, the Chesapeake SEC Reports), schedule or certificate furnished or to be furnished by Chesapeake to the Sellers or any of their representatives pursuant to the provisions hereof or in connection with the transactions contemplated hereby, contains any untrue statement of material fact or omits or will omit to state any material fact necessary in order to make the statements herein or therein, in light of the circumstances under which they were made, not misleading.

SECTION 4.9 POOLING MATTERS. The representations, warranties and covenants of Chesapeake set forth in the form of letter from Chesapeake to Coopers & Lybrand attached to this Agreement as Annex A-2 are true and correct in all material respects (except as such matters may be subject to the control of Xeron or its affiliates).

SECTION 4.10 ABSENCE OF CERTAIN CHANGES. Except as and to the extent set forth in Section 4.10 of the Chesapeake Disclosure Schedule, since December 31, 1997 Chesapeake has not:

(a) suffered any material Adverse Change; "Material Adverse Change" means (i) any material change in the nature of Chesapeake's business, assets, financial condition, results of operations, or prospects, (ii) the loss of a contract which would have a material adverse effect on Chesapeake, and (iii) any change that creates a material limitation on the ability of Chesapeake to conduct its business as heretofore conducted;

(b) agreed or planned, whether in writing or otherwise, to take any action described in this Section.

SECTION 4.11 AUDITED FINANCIAL STATEMENTS. Chesapeake shall have furnished to Xeron prior to the date of this Agreement copies of Chesapeake's Form 10-K for the fiscal years 1995, 1996 and 1997 filed with the Securities and Exchange Commission.

SECTION 4.12 NO UNDISCLOSED LIABILITIES. Except as and to the extent provided in the Chesapeake SEC Reports or Section 4.12 of the Chesapeake Disclosure Schedule, Chesapeake does not have any material liabilities (whether contingent or absolute, direct or indirect, known or unknown to Chesapeake or matured or unmatured) not fully reflected or fully reserved



against in the Chesapeake financial statements.

SECTION 4.13 NO DEFAULT. Except as set forth in Section 4.13 of the Chesapeake Disclosure Schedule, Chesapeake is not in default or violation (and no event has occurred that with notice or the lapse of time or both would constitute a default or violation) of any material term, condition or provision of (i) its Certificate of Incorporation or its By-Laws, (ii) any note, bond, mortgage, indenture, license, contract, agreement or other instrument or obligation to which Chesapeake is a party or by which it or any of its properties or assets are bound, or (iii) any order, writ, injunction, decree, statute, rule or regulation applicable to Chesapeake or any of its properties or assets, unless such default would not have a material adverse effect on Chesapeake.

SECTION 4.14 LITIGATION. Except as set forth in Chesapeake's SEC Reports or in Section 4.14 of the Chesapeake Disclosure Schedule, there is no material action, suit, proceeding, arbitration, or investigation pending or to the best of Chesapeake's knowledge, threatened by or before any Governmental Entity involving Chesapeake or any of its properties or assets. Except as set forth in Chesapeake's SEC Reports or in Section 4.14 of the Chesapeake Disclosure Schedule, neither Chesapeake nor any of its material properties or assets is subject to any order, writ, judgment, injunction, decree, determination or award.

SECTION 4.15 COMPLIANCE WITH APPLICABLE LAW. Except as set forth in Section 4.15 of the Chesapeake Disclosure Schedule, the business of Chesapeake has not been conducted in violation of any applicable law, ordinance, rule, regulation, decree or order of any Governmental Entity, unless such violation would not result in a material adverse effect on Chesapeake. Chesapeake holds all permits, licenses, variances, exemptions, orders and approvals of all Governmental Entities necessary for the lawful conduct of its businesses (the "Chesapeake Permits") and is in compliance with the terms of the Chesapeake Permits, unless the failure to obtain any Chesapeake Permits or be in compliance therewith will not result in a material adverse effect on Chesapeake. Except as set forth in Section 4.15 of the Chesapeake Disclosure Schedule, Chesapeake has not received any notification of any asserted present or past failure by Chesapeake to comply with such laws, rules or regulations or such Chesapeake Permits which have not been previously cured, and there is, to the knowledge of Chesapeake, no pending audit, investigation or other review by any Governmental Entity to determine the existence of any violation of such laws, rules or regulations or such Chesapeake Permits.

#### SECTION 4.16 TAXES.

(a) To the knowledge of Chesapeake, Chesapeake has duly filed with the appropriate governmental authorities all Tax Returns (as defined in Section 4.16(c)) required to be filed by it for all periods ending on or prior to the date hereof, and such Tax Returns are true, correct and complete in all material respects, and (ii) duly paid in full all Taxes (as defined in Section 4.16(b)) due in connection with or with respect to the filing of such Tax Returns and has paid all

other Taxes as are due, except such as are being contested in good faith by appropriate proceeding and with respect to which Chesapeake is maintaining reserves adequate for their payment. Neither the Internal Revenue Service (the "IRS") nor any other governmental entity or taxing authority or agency is now asserting, either through audits, administrative proceedings, court proceedings or otherwise, or threatening to assert against any deficiency or claim for additional Taxes. Chesapeake has not been granted any waiver of any statute of limitations with respect to, or any extension of a period for the assessment of, any Tax that is currently in effect. There are no tax liens on any assets of Chesapeake. Chesapeake has not received a ruling or entered into an agreement with the IRS, or any other governmental entity or taxing authority or agency that would have a material adverse effect on Chesapeake after the Effective Time. The accruals and reserve for Taxes reflected in Chesapeake's most recent balance sheet included in the Chesapeake SEC Reports are adequate to cover all Taxes accruable through the date thereof (including Taxes being contested) in accordance with generally accepted accounting principles. Except for Chesapeake and its subsidiaries' intercompany tax allocation agreements, no agreements relating to allocating or sharing of Taxes exist among Chesapeake and its subsidiaries and no tax indemnities given by Chesapeake in connection with a sale of stock or assets remain in effect.

(b) For purposes of this Section, the term "Taxes" shall mean all taxes, including, without limitation, income, gross receipts, excise, property, sales, withholding, social security, occupation, use, service, service use, license, payroll, franchise, transfer and recording taxes, fees and charges, windfall profits, severance, customs, import, export, employment or similar taxes, charges, fees, levies or other assessments imposed by the United States, or any state, local or foreign government or subdivision or agency thereof, whether computed on a separate, consolidated, unitary, combined or any other basis, and such terms shall include any interest, fines, penalties, or additional amounts and any interest in respect to any addition, fines, or penalties attributable or imposed or with respect to any such taxes, charges, fees, levies or other assessments.

(c) For purposes of this Section, the term "Tax Return" shall mean any return, report or other document or information required to be supplied to a taxing authority in connection with Taxes.

SECTION 4.17 LABOR RELATIONS. As of the date hereof, there is no material strike or other labor dispute pending against Chesapeake. Except as previously disclosed in writing to Xeron, no officer of Chesapeake has notified Chesapeake of any plans to terminate his employment with Chesapeake.

SECTION 4.18 RELATED PARTY CONTRACTS. Except as set forth in Section 4.18 of the Chesapeake Disclosure Schedule or the Chesapeake SEC Reports, Chesapeake has no agreements, arrangements or commitments with related parties (including shareholders, directors and officers), other than the related-party agreements described in Section 4.21 of the Chesapeake Disclosure Schedule. Except as set forth in.

Section 4.18 of the Chesapeake Disclosure Schedule, each of the related-party agreements was entered into between Chesapeake and the party thereto on an arm's length basis on terms less favorable to Chesapeake than it could obtain from an unrelated third party.

SECTION 4.19 ABSENCE OF CERTAIN PAYMENTS. Neither Chesapeake nor any of its affiliates or any of their respective officers, directors, employees or agents or other people acting on behalf of Chesapeake have (i) engaged in any activity prohibited by the United States Foreign Corrupt Practices Act of 1977 or any other similar law, regulation, decree, directive or order of any other country and (ii) without limiting the generality of the preceding clause (i), used any corporate or other funds for unlawful contributions, payments, gifts or entertainment, or made any unlawful expenditures relating to political activity to government officials or others. None of Chesapeake or any of its affiliates or any of their respective directors, officers, employees or agents of other persons acting on behalf of Chesapeake, has accepted or received any unlawful contributions, payments, gifts or expenditures.

SECTION 4.20 ENVIRONMENTAL MATTERS. Except as set forth in the Chesapeake Disclosure Schedule or in the Chesapeake SEC Reports, to Chesapeake's knowledge Chesapeake has no material liabilities relating to environmental matters.

SECTION 4.21 CONTRACTS AND COMMITMENTS. Except as set forth in Section 4.21 of the Chesapeake Disclosure Schedule:

a) Chesapeake is not restricted by agreement from carrying on its business anywhere in the world;

(b) Chesapeake has no obligation with respect to borrowed money, including debt obligations of its own or guarantees of or agreements to acquire any debt obligation of others not reflected on the Chesapeake financial statements; and

(c) Chesapeake has no power of attorney outstanding or any obligations or liabilities (whether absolute, accrued, contingent, or otherwise), as guarantor, surety, co-signor, endorser, co-maker or indemnitor for the obligation of any person, corporation, partnership, joint venture, association, organization, or other entity not reflected in the Chesapeake financial statements.

SECTION 4.22 KNOWLEDGE. The phrase "to the knowledge of Chesapeake" means to the knowledge of Chesapeake or any of its officers.

#### ARTICLE V COVENANTS OF XERON AND SELLERS

Each of the Sellers covenants and agrees as follows:

SECTION 5.1 CONDUCT OF BUSINESS PENDING THE MERGER. Except as otherwise specifically provided in this Agreement.

or as otherwise consented to in writing by Chesapeake, from the date of this Agreement to the Effective Time, Xeron will and the Shareholders will cause Xeron to) conduct its operations only in the ordinary and usual course of business and consistent with past practices and will preserve intact its present business organization, take all reasonable efforts to keep available the services of its present officers, employees and consultants and preserve its present relationships with licensors, licensees, customers, suppliers, employees, labor organizations and others with whom it has a significant business relationship. Without limiting the generality of the foregoing, and except as otherwise specifically provided in this Agreement or as set forth in Section 5.1 of the Xeron Disclosure Schedule, Xeron will not directly or indirectly (and the Shareholders will cause Xeron not to), from the date of this Agreement to the Effective Time, without the prior written consent of Chesapeake:

(a) adopt any amendment to or otherwise change its Articles of Incorporation or By-laws or other organizational documents;

(b) authorize for issuance, sale, pledge, disposition or encumbrance, or issue, sell, pledge, dispose of or encumber (whether through the issuance or granting of options, warrants, commitments, subscriptions, rights to purchase, convertible securities or otherwise), any capital stock of any class or any other securities of, or any other ownership interest in, Xeron or amend any of the terms of any such securities or agreements outstanding on the date hereof;

(c) reclassify, combine, split or subdivide any shares of its capital stock, declare, set aside or pay any dividend or other distribution (whether in cash, securities or property or any combination thereof) in respect of any class or series of its capital stock;

(d) redeem, purchase or otherwise acquire, or propose or offer to redeem, purchase or otherwise acquire, any outstanding shares of Xeron Common Stock or other securities of Xeron;

(e) organize any new subsidiary, acquire any capital stock or equity securities of any corporation or acquire any equity or ownership interest (financial or otherwise) in any business;

(f) (i) incur, assume or prepay any material liability, including without limitation, any indebtedness for borrowed money except in the ordinary course of business and consistent with past practice; (ii) assume, guarantee, endorse or otherwise become liable or responsible (whether directly, contingently or otherwise) for obligations of any third party, (iii) make any loans, advances or capital contributions to, or investments in, any third party, (iv) mortgage or pledge any of its material properties or assets, tangible or intangible, or create any material Lien thereupon other than Permitted Liens, or (v) authorize any new capital expenditures which, individually or in the aggregate, are in excess of \$25,000;

(g) license (except to end users in the

ordinary course of business, consistent with past practice and pursuant to a written license agreement) or otherwise transfer, dispose of, permit to lapse or otherwise fail to preserve any of Xeron's Intellectual Property, or dispose of or disclose to any person any trade secret, formula, process or know-how not theretofore a matter of public knowledge;

(h) enter into any agreement, contract, commitment or transaction other than in the ordinary course of business, consistent with past practices or that would be required to be included in Section 3.16 of the Xeron Disclosure Schedule if entered into prior to the date of this Agreement;

(i) increase the compensation payable or to become payable to its officers or employees, except for increases in salary or wages of non-officer employees of Xeron in accordance with past practices, or grant any severance or termination pay or stock options to, or enter into any employment or severance agreement with, any director, officer, or other employee of Xeron, or establish, adopt, enter into, or amend any collective bargaining, bonus, profit sharing, thrift, compensation, stock option, restricted stock, pension, retirement, deferred compensation, employment, termination, severance, or other plan, agreement, trust, fund, policy, or arrangement for the benefit of any current or former directors, officers, or employees;

(j) cancel any debts or waive, release or relinquish any material contract rights or other rights of substantial value other than in the ordinary course of business, consistent with past practices;

(k) authorize, recommend, propose or enter into or announce an intention to authorize, recommend, propose or enter into an agreement in principle or a definitive agreement with respect to any merger, consolidation, liquidation, dissolution, or business combination, any acquisition of a material amount of property or assets or securities, or any disposition of a material amount of property or assets or securities;

(l) make any change with respect to accounting policies or procedures in effect as of November 30, 1997 except as may be required by generally accepted accounting principles;

(m) pay, discharge or satisfy any claims, liabilities or obligations (absolute, accrued, asserted or unasserted, contingent or otherwise) other than the payment, discharge or satisfaction in the ordinary course of business, consistent with past practices, of liabilities reflected or reserved against in the Financial Statements or incurred in the ordinary course of business consistent with past practices since the date hereof; or

(n) commit or agree (in writing or otherwise) to take any of the foregoing actions or any action which would make any representation or warranty in this Agreement untrue or incorrect, either as of the date hereof or of the Effective Time, as if made as of such time.

SECTION 5.2 TAX STATUS. Shareholders and Xeron shall refrain from taking any action that would impair Xeron from being deemed a "C" corporation for federal income tax purposes at the Effective Time.

SECTION 5.3 ACCESS TO INFORMATION. Upon reasonable notice, Xeron shall afford to the officers, employees, accountants, counsel, environmental consultants and other representatives of Chesapeake, reasonable access, during normal business hours during the period prior to the Effective Time, to all its properties, books, contracts, commitments and records and, during such period, Xeron shall furnish promptly to Chesapeake all information concerning its business, properties and personnel as Chesapeake may reasonably request.

SECTION 5.4 NO SOLICITATION. Sellers will not and will cause their affiliates not to, and will cause their respective officers, directors, employees and agents retained by Sellers or any of their affiliates not to, initiate or solicit, directly or indirectly, any inquiries or the making of any proposal with respect to, or engage in negotiations concerning, provide any information or data to, or have any discussions with, any Third Party (as hereinafter defined) relating to, any public offering of securities of, or acquisition, business combination or purchase of all or any significant portion of the properties or assets of, or any equity interest in, Xeron (an "Acquisition Proposal"). Sellers and Xeron will immediately cease and cause to be terminated any existing activities, discussions or negotiations with any Third Party conducted heretofore with respect to any Acquisition Proposal. Sellers and Xeron shall immediately notify Chesapeake if, subsequent to the date hereof, any such negotiations, provision of information or data or discussions are entered into or made or any such inquiries are received in respect thereof, and shall provide details with respect thereto, including the identity of such Third Party and the price and terms of any Acquisition Proposal. As used in this Agreement, the term "Third Party" means any "person" or "group", as such terms are defined in Section 13(d) of the Exchange Act, other than Chesapeake or any affiliate of Chesapeake.

SECTION 5.5 FURTHER INFORMATION. As soon as practicable after such information becomes available, and in any event not later than thirty (30) days after the end of each fiscal month, Xeron shall provide to Chesapeake an unaudited consolidated balance sheet as of the end of such month and the related consolidated statements of results of operations and statements of cash flows for such period.

SECTION 5.6 AFFILIATES. Prior to the execution of this Agreement, Xeron shall deliver to Chesapeake a letter identifying all persons who may be deemed, as of the date of this Agreement, "affiliates" of Xeron for purposes of Rule 145 under the Securities Act. Xeron shall cause each person named in such letter to deliver a written agreement substantially in the form attached hereto as Exhibit 5.6.

SECTION 5.7 PUHCA. Each Shareholder covenants that he will take no action at any time that will cause the Shareholders to be deemed a "holding company" with respect to

Chesapeake as that term is defined in Section 2(a)(7) of the 1935 Act. With respect to Chesapeake, each Shareholder will act as an individual and on his own behalf, and not in concert with or as a group with any other Shareholder or any other person. The covenants contained in this Section 5.7 will continue with respect to a Shareholder as long as the Shareholders remain in the aggregate owners of ten percent or more of the outstanding voting securities of Chesapeake. This Section 5.7 and any claims for breach hereof are not subject to the limitations set forth in Article IX.

#### ARTICLE VI COVENANTS OF CHESAPEAKE

SECTION 6.1. CONDUCT OF BUSINESS PENDING THE MERGER. Except as otherwise specifically provided in this Agreement, as disclosed in its SEC filings or press releases, in connection with its ongoing acquisition program, in connection with Chesapeake's compensation program for directors or as otherwise consented to in writing by Xeron, from the date of this Agreement to the Effective Time, Chesapeake will conduct its operations in the ordinary and usual course of business and consistent with past practices, will preserve intact its present business organization, take all reasonable efforts to keep available the services of its present officers, employees and consultants and preserve its present relationships with licensors, licensees, customers, suppliers, employees, labor organizations and others with whom it has a significant business relationship, and will not

(a) adopt any amendment to or otherwise change its Certificate of Incorporation or By-laws or other organizational documents;

(b) authorize for issuance, sale, pledge, disposition or encumbrance, or issue, sell, pledge, dispose of or encumber (whether through the issuance or granting of options, warrants, commitments, subscriptions, rights to purchase, convertible securities or otherwise), any capital stock of any class or any other securities of, or any other ownership interest in, Chesapeake or amend any of the terms of any such securities or agreements outstanding on the date hereof; or

(c) redeem, purchase or otherwise acquire, or propose or offer to redeem, purchase or otherwise acquire, any outstanding shares of Chesapeake Common Stock or securities of Chesapeake.

#### ARTICLE VII MUTUAL COVENANTS

SECTION 7.1 REASONABLE EFFORTS. Subject to the terms and conditions of this Agreement, each of the parties hereto agrees to use all reasonable efforts to take, or cause to be taken, all actions, and to do, or cause to be done, all things necessary, proper or advisable to assure that all conditions to Closing set forth in Article VIII of this Agreement are satisfied as expeditiously as possible.

including, without limitation, the preparation and filing of all forms, registrations and notices required to be filed to consummate the transactions contemplated hereby and the taking of such actions as are necessary to obtain any requisite approvals, consents, orders, exemptions or waivers by any public or private third party. Each party shall promptly consult with the other with respect to, provide any necessary information with respect to and provide the other (or its counsel) copies of, all filings made by such party with any Governmental Entity in connection with this Agreement and the transactions contemplated hereby.

SECTION 7.2 BROKERS OR FINDERS. Each of the Sellers and Chesapeake represents, as to itself, its subsidiaries and its affiliates, that no agent, broker, investment banker, financial advisor or other firm or person is or will be entitled to any broker's or finder's fee or any other commission or similar fee in connection with any of the transactions contemplated by this Agreement. The Sellers and Chesapeake agree to indemnify and hold the other harmless from and against any such claims, liabilities or obligations with respect to any broker's or finder's fees, commissions or expenses determined to be owed by them or it.

SECTION 7.3 NOTIFICATION OF CERTAIN MATTERS. The Sellers shall give prompt notice to Chesapeake and CPK-Sub-C, and Chesapeake and CPK-Sub-C shall give prompt notice to the Sellers, of the occurrence (or non-occurrence) of any event of which Sellers, Chesapeake or CPK-Sub-C has knowledge, respectively, the occurrence (or non-occurrence) of which would be likely to cause any representation or warranty contained in this Agreement to be untrue or inaccurate in any respect (including as of the Effective Time) and of any failure of either party to comply with or satisfy any covenant, condition or agreement to be complied with or satisfied by it hereunder; provided, however, that delivery of any notice pursuant to this Section 7.3 shall not limit or otherwise affect the remedies available to either party hereunder.

SECTION 7.4 FEES AND EXPENSES. Whether or not the Merger is consummated, all costs and expenses incurred in connection with this Agreement and the transactions contemplated hereby shall be paid by the party incurring such expenses in the normal course of business.

SECTION 7.5 FURTHER ASSURANCES. After the Closing, Chesapeake and the Sellers shall from time to time, at the request of the other party and without further cost or expense to the requesting party, execute and deliver such other instruments of conveyance and transfer and take such other actions as such other party may reasonably request in order more effectively to carry out this Agreement.

#### ARTICLE VIII CONDITIONS

SECTION 8.1 CONDITIONS TO EACH PARTY'S OBLIGATION TO EFFECT THE MERGER. The respective obligations of each party to effect the Merger shall be subject to the



satisfaction at or prior to the Effective Time of the following conditions: no statute, rule, regulation, executive order, decree or injunction shall have been enacted, entered, promulgated or enforced by any United States court or Governmental Entity of competent jurisdiction that prohibits the consummation of the Merger and shall be in effect.

#### SECTION 8.2 CONDITIONS OF OBLIGATIONS OF THE SELLERS.

The obligation of the Sellers to effect the Merger is further subject to the satisfaction at or prior to the Effective Time of the following conditions, unless waived by Sellers:

- (a) The representations and warranties of Chesapeake set forth in this Agreement shall be true and correct in all respects as of the date of this Agreement and as of the Effective Time (except that representations and warranties that are made as of a specified date shall be true and correct in all respects as of such specified date).
- (b) Chesapeake shall have performed and complied, in all respects, with all obligations and covenants required to be performed or complied with by it under this Agreement at or prior to the Effective Time.
- (c) Chesapeake shall have obtained all consents, approvals, authorizations and permits required from third parties and any Governmental Entity (applicable to Chesapeake and its subsidiaries) necessary for the consummation by Chesapeake of the transactions contemplated by this Agreement.
- (d) Sellers shall have received from Chesapeake an officer's certificate substantially in the form of Exhibit 8.2(d) attached hereto.
- (e) The Stock Consideration to be issued pursuant to this Agreement shall have been listed on the NYSE.
- (f) Chesapeake shall have executed and delivered the letter to Coopers & Lybrand in the form of Annex A-2 attached hereto.
- (g) Chesapeake shall have delivered executed Employment Agreements for J. Phillip Keeter and Earnest A. Allen, Jr. in the form of Annexes B-1 and B-2 hereto; and Chesapeake shall have delivered executed Employment Agreements for Patrick Armand, Carl E. Mendenhall, David Snyder and Marilyn Johnson satisfactory to the parties thereto.
- (h) Chesapeake shall have caused the Shareholders to be released from their personal guaranties of the indebtedness of Xeron listed on Schedule 8.2(h) hereto.
- (i) From the date of this Agreement through the Effective Time, Chesapeake shall not have suffered a Material Adverse Change.

#### SECTION 8.3 CONDITIONS OF OBLIGATIONS OF CHESAPEAKE.

The obligation of Chesapeake to effect the Merger is further subject to the satisfaction at or prior to the

Effective Time of the following conditions, unless waived by Chesapeake:

(a) The representations and warranties of Sellers set forth in this Agreement shall be true and correct in all respects as of the date of this Agreement and as of the Effective Time (except that representations and warranties that are made as of a specified date shall be true and correct in all respects as of such specified date).

(b) Sellers shall have performed and complied with, in all respects, all obligations and covenants required to be performed or complied with by it under this Agreement at or prior to the Effective Time.

(c) Sellers shall have obtained all consents, approvals, authorizations and permits required from third parties and any Governmental Entity (applicable to Xeron or any of its shareholders) necessary for the consummation by Sellers of the transactions contemplated by this Agreement.

(d) The Stock Transfer Restriction Agreement dated September 28, 1987, as amended or supplemented, shall have been terminated in writing in accordance with the terms thereof.

(e) Chesapeake shall have received from Xeron an officer's certificate substantially in the form of Exhibit 8.3(e) attached hereto.

(f) Chesapeake shall have received from each Shareholder a certificate substantially in the form of Exhibit 8.3(f) attached hereto.

(g) Chesapeake shall have received from Lowrey & Millikin, L.L.P., counsel to the Sellers, an opinion substantially in the form of Exhibit 8.3(g) attached hereto.

(h) Chesapeake shall have received from each of the Shareholders, investment representation letters substantially in the form of Exhibit 8.3(h) attached hereto.

(i) From the date of this Agreement through the Effective Time, Xeron shall not have suffered a Material Adverse Change.

(j) All necessary approvals from the Delaware Public Service Commission regarding the issuance of the shares of Chesapeake Common Stock shall have been granted by final order.

(k) All rights of first refusal pursuant to the Articles of Incorporation of Xeron or otherwise held by any Shareholder shall have been waived or terminated in writing.

(l) All waiting periods shall have expired and/or all necessary approvals, authorizations, consents, or waivers have been received for the consummation of the transaction pursuant to the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended.

(m) Xeron shall have executed and delivered the letter to Coopers & Lybrand in the form of Annex A-1 attached hereto.

(n) Coopers & Lybrand shall have delivered to Chesapeake an opinion letter confirming that the merger may be accounted for as a pooling of interests under the requirements of Accounting Principles Board Opinion (APB) No. 16, Business Combinations, and the related published interpretations of the American Institute of Certified Public Accountants and the Financial Accounting Standards Board, and the published rules and regulations of the Securities and Exchange Commission.

(o) The Sellers shall have delivered executed Employment Agreements for J. Phillip Keeter and Earnest A. Allen, Jr. in the form of Annexes B-1 and B-2 hereto; and the Sellers shall have delivered executed Employment Agreements for Patrick E. Armand, Carl E. Mendenhall, David Snyder and Marilyn Johnson satisfactory to Chesapeake.

(p) The Sellers shall have provided Chesapeake with such representations and evidence as Chesapeake's counsel advises are necessary or appropriate to ensure compliance with applicable federal and state securities laws.

#### ARTICLE IX SURVIVAL AND INDEMNIFICATION

SECTION 9.1 SURVIVAL OF REPRESENTATIONS AND WARRANTIES. All statements, certifications, representations, and warranties provided for herein shall survive beyond the Effective Time and continue in full force and effect at all times as provided in this Article IX (and shall not in any manner be affected or impaired by the consummation of the transactions contemplated by this Agreement or by any investigation made by or on behalf of any party) until the termination of this Agreement pursuant to Section 10.1 or the period for identifying a claim of breach or default pursuant to the limitations prescribed under Section 9.2(d)(i) and (ii) shall have expired.

#### SECTION 9.2 INDEMNIFICATION.

(a) INDEMNITY BY CHESAPEAKE. Chesapeake shall indemnify and defend and hold each Shareholder harmless from and against all claims, liabilities, damages, losses and expenses (including reasonable attorneys' fees) of every kind and character (exclusive however of any amounts covered by Section 9.2(b)) resulting from or relating to or arising out of the inaccuracy, nonfulfillment, nonperformance or breach of any representation, warranty, covenant, agreement or obligation of Chesapeake contained herein.

(b) INDEMNITY BY THE SHAREHOLDERS. Each Shareholder shall indemnify and defend and hold Chesapeake and its affiliates harmless from and against all claims, liabilities, damages, losses and expenses (including reasonable attorneys' fees) of every kind and character (exclusive however of any amounts covered by Section 9.2(a)) incurred by Chesapeake and its affiliates and resulting from

or relating to or arising out of the inaccuracy, nonfulfillment, nonperformance or breach of any representation, warranty, covenant, agreement or obligation of the Sellers contained herein.

c) THIRD PARTY CLAIMS. If a claim for which indemnification may be sought under this Section 9.2 is asserted by third parties (including any environmentally related remedial or clean up work) (the "Third Party Claims"), such Third Party Claim will be subject to the following terms and conditions:

(i) upon receipt of written notice of any Third Party Claim asserted against, imposed upon or incurred by Chesapeake and its affiliates or the Shareholders, as the case may be (the "Indemnified Party"), the party from whom indemnification is sought (the "Indemnifying Party") may, at its own expense, participate in and, upon notice to the Indemnified Party undertake the defense thereof by counsel of its own choosing, which counsel shall be reasonably satisfactory to the Indemnified Party, provided that, if in the Indemnified Party's reasonable judgment a conflict of interest may exist between such Indemnified Party and the Indemnifying Party with respect to such Third Party Claim, such Indemnified Party shall be entitled to select counsel of its own choosing to defend the Third Party Claim (with the fees and costs of such counsel being at the Indemnifying Party's sole cost and expense);

(ii) if (A) within a reasonable time after written notice to the Indemnifying Party of a Third Party Claim, the Indemnifying Party fails to notify the Indemnified Party that it will assume the defense of the Third Party Claim or (B) within a reasonable time after written notice to the Indemnified Party of its intention to undertake the defense of any Third Party Claim, the Indemnifying Party fails to defend the Indemnified Party, the Indemnified Party will have the right to undertake the defense, compromise or settlement of such Third Party Claim for the account and at the risk of the Indemnifying Party;

(iii) anything in this Section 9.2(c) to the contrary notwithstanding, if there is a reasonable probability in the Indemnified Party's judgment that a claim may materially and adversely affect the Indemnified Party, other than as a result of money damages or other money payments, the Indemnified Party will have the right to defend, co-defend, compromise or settle such Third Party Claim (with full disclosure of the proposed settlement terms being given to the Indemnifying Party prior to settlement thereof) by selecting counsel of its own choosing (with the fees and costs of such counsel being the Indemnified Party's sole cost and expense);

(iv) the Indemnified Party shall cooperate fully in all reasonable respects with the Indemnifying Party in any such defense, compromise or settlement including, without limitation, by making available to the Indemnifying Party all pertinent information and all books and records under the control of the Indemnified Party;

(v) the Indemnifying Party shall not compromise or settle

any such action, suit, proceeding, claim or demand without the prior written approval of the Indemnified Party; provided that, if such prior written approval is unreasonably withheld by the Indemnified Party, the liability of the Indemnifying Party with respect to such action, suit, proceeding, claim or demand shall be limited to the amount of the settlement recommended by the Indemnifying Party and not approved by the Indemnified Party.

(d) LIMITATIONS. The Indemnified Party shall have no claim for indemnification hereunder or other claims against the Indemnifying Party with respect to this Agreement (other than a claim arising out of the knowing, fraudulent or intentional breach of any provision of this Agreement) unless such claim is identified:

(i) with respect to claims relating to Sections 3.11 and 4.16 within the relevant statute of limitations for assessment and collection of additional taxes; or

(ii) with respect to all other claims, within the earlier of

(A) one (1) year following the Effective Time or (B) the date on which an independent audit report on Chesapeake is issued which reflects the Merger.

If such a claim for indemnification or such other recourse is not identified in writing within the appropriate time period provided above, such claim against and right to indemnification from the Indemnifying Party shall be deemed released, waived and relinquished for all purposes. Notwithstanding any other provisions of this Section 9.2 or other provisions of this Agreement to the contrary (except as expressly stated in Section 5.7 and Article XI hereof), no indemnification shall be payable to an Indemnified Party by an Indemnifying Party unless the total of all claims for indemnification by an Indemnified Party under this Agreement shall exceed \$500,000 in the aggregate, whereupon the excess of the amount of such claims over \$500,000 shall be recoverable in accordance with the terms hereof, subject to the maximum amounts set forth in Section 9.2(e).

(e) MAXIMUM AMOUNT OF INDEMNIFICATION. The maximum amount payable to Chesapeake by the Shareholders in the aggregate pursuant to this Section 9.2 shall be \$500,000 and the maximum amount payable by each Shareholder shall be such Shareholder's proportionate ownership percentage of the outstanding Xeron Common Stock immediately prior to the Merger multiplied by \$500,000. The maximum amount payable to the Shareholders, in the aggregate, by Chesapeake pursuant to this Section 9.2, shall be \$500,000. Notwithstanding the foregoing provisions, the respective maximum amounts shall not be applicable to amounts owed arising out of the knowing, fraudulent or intentional breach of any provision of this Agreement by an Indemnifying Party. Furthermore, in no event shall Chesapeake be obligated to pay the Shareholders any indemnification if the market price of Chesapeake Common Stock for the last day of the preceding month end is \$17 per share

or above, as adjusted for stock splits, stock dividends and similar events.

(f) REIMBURSEMENT IN STOCK. Amounts due to Chesapeake under this Article IX shall be paid first in Chesapeake Common Stock and, to the extent the Shareholders do not hold sufficient shares of Chesapeake Common Stock to pay the amount due, then in cash. For purposes of this Section 9.2(f), the value of such Chesapeake Common Stock shall be deemed to be the closing price of Chesapeake Common Stock on the New York Stock Exchange on the day the Effective Time occurs (or the next succeeding trading day on which shares are sold if none are sold on the day the Effective Time occurs).

#### ARTICLE X TERMINATION AND AMENDMENT

SECTION 10.1 TERMINATION. This Agreement may be terminated at any time prior to the Effective Time:

- (a) by mutual consent of Chesapeake and the Sellers;
- (b) by either Chesapeake or the Sellers, if the Merger shall not have been consummated before May 31, 1998 (unless the failure to consummate the Merger by such date shall be due to the action or failure to act of the party seeking to terminate); or
- (c) by either Chesapeake or the Sellers, if any permanent injunction or other order of a court or other competent authority preventing the consummation of the Merger shall have become final and nonappealable.

SECTION 10.2 EFFECT OF TERMINATION. In the event of the termination and abandonment of this Agreement pursuant to Section 10.1 hereof, this Agreement shall forthwith become void and have no effect, without any liability on the part of any party hereto or its affiliates, directors, officers or shareholders. Notwithstanding the foregoing, nothing contained in this Section 10.2 shall relieve any party from liability for any material breach of any covenant of this Agreement or any material breach or misrepresentation of the representations or warranties contained herein, which occurred prior to such termination.

SECTION 10.3 AMENDMENT. This Agreement may be amended by the parties hereto at any time prior to the Effective Time. This Agreement may not be amended except by an instrument in writing signed by or on behalf of each of the parties hereto.

SECTION 10.4 EXTENSION, WAIVER. At any time prior to the Effective Time, the parties may, to the extent legally allowed, (i) extend the time for the performance of any of the obligations or other acts of the other parties hereto, (ii) waive any inaccuracies in the representations and warranties of the other parties hereto contained herein or in any document delivered pursuant hereto and (iii) waive compliance with any of the agreements or conditions contained herein by

the other parties hereto. Any agreement on the part of a party hereto to any such extension or waiver shall be valid only if set forth in a written instrument signed on behalf of such party.

#### ARTICLE XI NON-COMPETITION AGREEMENT

SECTION 11.1 COVENANT NOT TO SOLICIT CUSTOMERS, HIRE EMPLOYEES OR COMPETE. For and in consideration of the purchase of Xeron and in addition to any non-competition agreements in the Employment Agreements attached as Annex B hereto, each of the Shareholders agrees that he will not, for a period of three years following the Effective Time:

(a) directly or indirectly, on his own behalf or on behalf of any other person or entity other than Chesapeake, solicit, or attempt to solicit, for the purpose of providing any product or service of the same or similar kind or character as any product or service sold, provided or under development by Xeron prior to the Effective Date, any person or entity that is or was a customer or a prospective customer of Xeron.

(b) directly or indirectly, on his own behalf or on behalf of any other person or entity other than Chesapeake, solicit for employment or hire any employee or former employee of Xeron or any affiliate of Xeron who is or was employed by Xeron or any affiliate during the twelve months preceding the Effective Date.

(c) (i) directly or indirectly engage in, (ii) have any interest in any person, firm, corporation or other entity that directly or indirectly engages in, or (iii) perform any services for any person, firm, corporation or other entity that directly or indirectly engages in, the same or similar lines of business as Xeron, except for such Shareholders' ownership of the stock of Chesapeake, except for ownership of interests in publicly traded companies where such ownership represents less than one percent of the outstanding shares of such publicly traded company.

Nothing in this Section 11.1 is intended or shall restrict the right of any Shareholder to engage in speculative transactions in propane futures traded on a public exchange for his own individual investment account (or the investment account of a member of his immediate family) and not for the benefit of any third party, provided that any such transaction shall be permitted only if (1) executed on a public exchange and (2) such transaction shall not have an adverse effect on Xeron. This Article XI and any claims for breach hereof are not subject to the limitations set forth in Article IX.

#### ARTICLE XII MISCELLANEOUS

SECTION 12.1 NOTICES. All notices and other communications hereunder shall be in writing, and shall be deemed

given upon receipt if delivered personally, sent by facsimile transmission (receipt of which is confirmed) or by certified or registered mail, return receipt requested, or by a nationally recognized private overnight courier to the parties at the following addresses (or at such other address for a party as shall be specified by like notice):

(a) if to the Shareholders, to:

J. Phillip Keeter  
1405 Colony Circle  
Longview, TX 75604  
Fax: (903) 236-6807

Earnest A. Allen, Jr.  
3126 Robinson Road  
Missouri City, TX 77459

Patrick E. Armand  
9119 Devoncroft  
Houston, TX 77037

(b) if to Xeron, to

Xeron, Inc.  
9301 Southwest Freeway, Suite 325  
Houston, TX 77074  
Attn: Earnest A. Allen, Jr.  
Fax: (713) 988-3476

with a copy to:

J. Richard Millikin, Jr.  
Lowrey & Millikin, L.L.P.  
1127 Judson Road, Suite 141  
Longview, TX 75601  
Fax: (903) 236-3050

(c) if to Chesapeake, to:

Chesapeake Utilities Corporation  
909 Silver Lake Boulevard  
Dover, Delaware 19904  
Attention: John R. Schimkaitis  
Fax: (302) 734-6750

with a copy to:

Covington & Burling  
1201 Pennsylvania Avenue, N.W.  
Washington, D.C. 20004  
Attention: Ruth S. Epstein  
Fax: (202) 662-6291

SECTION 12.2 DESCRIPTIVE HEADINGS. The descriptive headings herein are inserted for convenience only and are not intended to be part of or to affect the meaning or interpretation of this Agreement.

SECTION 12.3 COUNTERPARTS. This Agreement may be executed in two or more counterparts, all of which shall be



considered one and the same agreement and shall become effective when two or more counterparts have been signed by each of the parties and delivered to the other parties, it being understood that all parties need not sign the same counterpart.

SECTION 12.4 ENTIRE AGREEMENT; ASSIGNMENT. This Agreement (a) constitutes the entire agreement and supersedes all prior agreements and understandings, both written and oral, among the parties with respect to the subject matter hereof and (b) shall not be assigned by operation of law or otherwise.

SECTION 12.5 GOVERNING LAW. This Agreement shall be governed and construed in accordance with the laws of the State of Delaware without regard to any applicable principles of conflicts of law.

SECTION 12.6 SPECIFIC PERFORMANCE. The parties hereto agree that if any of the provisions of this Agreement were not performed in accordance with their specific terms or were otherwise breached, irreparable damage would occur, no adequate remedy at law would exist and damages would be difficult to determine, and that the parties shall be entitled to specific performance of the terms hereof, in addition to any other remedy at law or equity.

SECTION 12.7 PUBLICITY. Chesapeake may issue or cause the publication of any press release or other public announcement or make any filing with the SEC with respect to the transactions contemplated by this Agreement as it deems appropriate; provided that, to the extent practicable, Chesapeake shall provide the Shareholders with a copy of any such press release or other public announcement or filing prior to the time of release or filing. The Sellers shall not issue or cause the publication of any press release or other public announcement with respect to the transactions contemplated by this Agreement without the prior approval of Chesapeake.

SECTION 12.8 PARTIES IN INTEREST. This Agreement shall be binding upon and inure solely to the benefit of each party hereto and nothing in this Agreement, express or implied, is intended to or shall confer upon any other person or persons any rights, benefits or remedies of any nature whatsoever under or by reason of this Agreement.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be signed (where applicable by their respective officers thereunto duly authorized), as of the date first written above.

CHESAPEAKE UTILITIES CORPORATION

By: /s/ John R. Schimkaitis

-----  
Name: John R. Schimkaitis  
Title: President

CPK-SUB-C, INC.

By: /s/ John R. Schimkaitis



-----  
Name: John R. Schimkaitis  
Title: President

XERON, INC.

By: /s/ Earnest A. Allen, Jr.  
-----

Name: Earnest A. Allen, Jr.  
Title: Chief Executive Officer

SHAREHOLDERS

/s/ J. Phillip Keeter  
-----

J. Phillip Keeter

/s/ Earnest A. Allen, Jr.  
-----

Earnest A. Allen, Jr.

/s/ Patrick E. Armand  
-----

Patrick E. Armand

Exhibit II.

FOR IMMEDIATE RELEASE:  
April 29, 1998  
NYSE Symbol: CPK

CHESAPEAKE UTILITIES CORPORATION  
ENTERS AGREEMENT TO PURCHASE THE STOCK  
OF XERON, INC.

DOVER, DELAWARE - Chesapeake Utilities Corporation ("Chesapeake") announced today that it has signed an agreement to purchase all of the outstanding shares of Xeron, Inc. ("Xeron"), a privately held natural gas liquids trading company headquartered in Houston, Texas. Xeron will be operated as a subsidiary of Chesapeake. In the transaction, which will be accounted for as a pooling of interests, Xeron shareholders will receive 475,000 shares of Chesapeake common stock for all the outstanding common stock of Xeron. After the purchase of Xeron's stock, the total number of Chesapeake outstanding shares will be approximately 5,064,000.

Excluding one-time merger costs, this transaction is not expected to have a dilutive effect on earnings per share. The purchase, which is subject to regulatory and other required approvals and conditions of closing, is expected to close by May 31, 1998.

Chesapeake Utilities Corporation is a diversified utility company engaged in natural gas distribution and transmission, propane distribution, advanced information services and water treatment. Chesapeake's three natural gas distribution divisions serve approximately 35,800 residential, commercial and industrial customers throughout central and southern Delaware, Maryland's Eastern Shore and Central Florida. The Company's propane segment serves approximately 34,000 customers in central and southern Delaware and the Eastern Shore region of Maryland and Virginia.

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For more information, please contact:  
Michael P. McMasters, Vice President,  
Treasurer & Chief Financial Officer  
Chesapeake Utilities Corporation, 302.734.6798

Beth W. Cooper, Assistant Treasurer  
Chesapeake Utilities Corporation, 302.734.6015

This press release includes forward-looking information relating to the proposed business combination, including its anticipated impact on earnings per share. This forward-looking information involves risks and uncertainties that could cause actual results to differ materially, including without limitation, whether or not the proposed acquisition actually occurs, actual performance for the periods indicated, the actual costs of the acquisition and the ability of the combined company to execute the anticipated integration and realize the expected synergies.

**DRAFT**

**REGISTRATION RIGHTS AGREEMENT**

This Registration Rights Agreement (the "Agreement") is made and entered into as of \_\_\_\_\_, 1998, by and between Chesapeake Utilities Corporation, a Delaware corporation (the "Company") and \_\_\_\_\_ ("Shareholder").

This Agreement is made as contemplated by that certain Agreement and Plan of Merger dated as of April \_\_, 1998, by and among the Company, CPK Sub-C, Inc., a Delaware corporation and wholly-owned subsidiary of the Company ("CPK Sub-C"), Xeron, Inc., a Mississippi corporation ("Xeron"), J. Phillip Keeter, Earnest A. Allen, Jr., and Patrick Armand (the "Merger Agreement"), which provides for the merger of CPK Sub-C with and into Xeron (the "Merger"). Whereas the securities to be delivered to Shareholder pursuant to the Merger Agreement are restricted securities, as defined in Rule 144 under the Securities Act of 1933, in order to induce Xeron and Shareholder to enter into the Merger Agreement, the Company has agreed to provide the registration rights set forth in this Agreement.

For good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the parties hereby agree as follows:

1. Securities Subject to this Agreement. The securities entitled to the benefits of this Agreement are the shares of common stock, par value \$.4867 per share, of the Company (the "Common Stock") issued to Shareholder in accordance with the terms of the Merger Agreement (the "Registrable Securities").

2. Registration.

(a) Within 60 days following the time at which results covering at least 30 days of post-Merger combined operations of the Company have been filed with the Securities and Exchange Commission (the "Commission"), sent to stockholders of the Company or otherwise publicly issued, the Company will, subject to the terms of this Agreement, and subject to the full cooperation of Shareholder, at its expense, file with the Commission a registration statement (the "Registration Statement") covering the sale by Shareholder of the Registrable Securities. The Company will use its reasonable best efforts to cause the Registration Statement to become effective as promptly as practicable and to maintain the effectiveness of the Registration Statement for a period of three (3) years from the Effective Time, as that term is defined in the Merger Agreement, or such shorter time as may be required by Rule 144(k) under the Securities Act of 1933, as amended (the "Securities Act"), or any successor provision. The Company may postpone for a

# DRAFT

reasonable period of time, not to exceed 60 days, the filing or effectiveness of the Registration Statement, or the undertaking of any work by the Company with respect to the preparation of the Registration Statement, if the Board of Directors of the Company in good faith determines that such filing or registration would reasonably be expected to have a material adverse effect on any plan or proposal by the Company with respect to any financing, acquisition, recapitalization, reorganization or other material transaction.

(b) Before filing with the Commission the Registration Statement or any amendments or supplements thereto, the Company will furnish to Shareholder for review copies of all documents proposed to be filed.

(c) The Company shall furnish to Shareholder such number of copies of the Registration Statement and of each amendment and supplement thereto (in each case including all exhibits), such number of copies of the prospectus included in such Registration Statement (including each preliminary prospectus and summary prospectus), and such other documents as Shareholder may reasonably request in order to facilitate the disposition of the Registrable Securities by Shareholder.

(d) The Company shall use its best efforts to register or qualify the Registrable Securities covered by the Registration Statement under such other securities or blue sky laws of such jurisdictions as Shareholder may reasonably request, provided that the Company shall not for any such purpose be required to qualify generally to do business as a foreign corporation in any jurisdiction where, but for the requirements of this Section 2(d), it would not be obligated to be so qualified, to subject itself to taxation in any such jurisdiction, or to consent to general service of process in any such jurisdiction (a general service of process would not include a consent on Form U-2 or its substantial equivalent).

(e) The Company may require Shareholder to furnish the Company with such information regarding Shareholder and pertinent to the disclosure requirements relating to the registration and the distribution of the Registrable Securities as the Company may from time to time reasonably request.

(f) If Shareholder determines to distribute the Registrable Securities in an underwritten offering, all costs, fees, and disbursements of underwriters and all underwriting discounts, commissions and transfer taxes relating to such distribution will be the sole responsibility of Shareholder.

(g) Shareholder agrees that upon notice from the Company he will suspend from time to time all sales of the Registrable Securities for such

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period of time as is required to permit the Company to complete any future financing transaction involving an underwritten offering by the Company of its Common Stock. Shareholder will not be required to suspend sales of the Registrable Securities (pursuant to this Section 2(g)) for more than three months in any 12-month period.

(h) Shareholder agrees that, upon receipt of any notice from the Company that the Company has become aware that the prospectus included in the Registration Statement, as then in effect, includes an untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading in the light of the circumstances then existing, Shareholder will forthwith discontinue disposition of Registrable Securities pursuant to the Registration Statement until Shareholder's receipt of copies of a properly supplemented or amended prospectus and, if so directed by the Company, Shareholder will deliver to the Company all copies, other than permanent file copies then in Shareholder's possession, of the prospectus covering Registrable Securities current at the time of receipt of such notice. The Company will diligently prepare an amended prospectus and deliver sufficient copies thereof to Shareholder.

3. Indemnification.

(a) Indemnification by the Company. The Company will indemnify and hold harmless, to the extent permitted by law, Shareholder against any and all losses, claims, damages or liabilities, joint or several, to which Shareholder may become subject under the Securities Act or otherwise, insofar as such losses, claims, damages or liabilities (or actions or proceedings, whether commenced or threatened, in respect thereof) arise out of or are based upon any untrue statement or alleged untrue statement of any material fact contained in the Registration Statement, any preliminary prospectus, final prospectus or summary prospectus contained therein, or any amendment or supplement thereto, or any omission or alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading, and subject to the provisions of Section 3(c), the Company will reimburse Shareholder for any legal or any other expenses reasonably incurred by it in connection with investigating or defending any such loss, claim, liability, action or proceeding; provided, however, that the Company shall not be liable to Shareholder in any such case to the extent that any such loss, claim, damage, liability (or action or proceeding in respect thereof) or expense arises out of or is based upon an untrue statement or alleged untrue statement or omission or alleged omission made in the Registration Statement, any such preliminary prospectus, final prospectus, summary prospectus, amendment or supplement thereto in reliance upon and in conformity with information furnished

# DRAFT

to the Company by Shareholder for use in the preparation thereof; and provided further that the Company shall not be liable under this Section 3(a) to Shareholder to the extent that any such loss, claim, damage, liability (or action or proceeding in respect thereof) or expense arises out of Shareholder's failure to send or give a copy of the final prospectus, as the same may be then supplemented or amended, to the person asserting an untrue statement or alleged untrue statement or omission or alleged omission at or prior to the written confirmation of the sale of Registrable Securities to such person if such statement or omission was corrected in such final prospectus. Such indemnity shall remain in full force and effect regardless of any investigation made by or on behalf of Shareholder and shall survive the transfer of such securities by Shareholder.

(b) Indemnification by Shareholder. Shareholder will indemnify and hold harmless (in the same manner and to the same extent as set forth in subdivision (a) of this Section 3) the Company, each director of the Company and each officer of the Company with respect to any statement or alleged statement in or omission or alleged omission from the Registration Statement, any preliminary prospectus, final prospectus or summary prospectus contained therein, or any amendment or supplement thereto, if such statement or alleged statement or omission or alleged omission was made in reliance upon and in conformity with information furnished to the Company by Shareholder for use in the preparation of the Registration Statement, preliminary prospectus, final prospectus, summary prospectus, amendment or supplement thereto. Such indemnity shall remain in full force and effect, regardless of any investigation made by or on behalf of the Company, any director of the Company or any officer of the Company and shall survive the transfer of such securities by Shareholder.

(c) Notice of Claims, etc. Promptly after receipt by an indemnified party of notice of the commencement of any action or proceeding or threat of claim involving a claim referred to in the preceding subdivisions of this Section 3, such indemnified party will, if a claim in respect thereof is to be made against an indemnifying party, give written notice to the latter of the commencement of such action or threat of claim, provided that the failure of any indemnified party to give notice as provided herein shall not relieve the indemnifying party of its obligations under the preceding subdivisions of this Section 3, except to the extent that the indemnifying party is prejudiced by such failure to give notice. In case any such action is brought against an indemnified party, unless and except to the extent that in the reasonable judgment of the indemnified party, based on advice of counsel, a conflict of interest between such indemnified and indemnifying parties exists in respect of such claim, the indemnifying party shall be entitled to participate in and to assume the defense thereof, jointly with any other indemnifying party similarly notified, to the extent that the indemnifying party may wish, with counsel reasonably



satisfactory to such indemnified party, and after notice from the indemnifying party to such indemnified party of its election so to assume the defense thereof, the indemnifying party shall not be liable to such indemnified party for any legal or other expenses subsequently incurred by the latter in connection with the defense thereof other than reasonable costs of investigation. No indemnified party shall consent to entry of any judgment or enter into any settlement of any such action the defense of which has been assumed by an indemnifying party without the consent of such indemnifying party.

(d) Indemnification Payments. The indemnification required by this Section 3 shall be made by periodic payments of the amount thereof during the course of the investigation or defense, as and when bills are received or expense, loss, damage or liability is incurred subject to the receipt of such documentary support therefor as the indemnifying party may reasonably request.

(c) Contribution. If the indemnification provided for in this Section 3 shall for any reason be unavailable to an indemnified party in respect of any loss, claim, damage or liability, or any action in respect thereof, referred to therein, then each indemnifying party shall, in lieu of indemnifying such indemnified party, contribute to the amount paid or payable by such indemnified party as a result of such loss, claim, damage or liability, or action in respect thereof, in such proportion as shall be appropriate to reflect the relative fault of the indemnifying party on the one hand and the indemnified party on the other with respect to the statements or omission which resulted in such loss, claim, damage or liability, or action in respect thereof, as well as any other relevant equitable considerations. The relative fault shall be determined by reference to whether the untrue or alleged untrue statement of a material fact or omission or alleged omission to state a material fact relates to information supplied by the indemnifying party on the one hand or the indemnified party on the other, the intent of the parties and their relative knowledge, access to information and opportunity to correct or prevent such statement or omission, but not by reference to an indemnified party's stock ownership in the Company. The amount paid or payable by an indemnified party as a result of the loss, claim, damage or liability, or action in respect thereof, referred to above in this paragraph shall be deemed to include, for purposes of this paragraph, any legal or other expenses reasonably incurred by such indemnified party in connection with investigating or defending any such action or claim. No person guilty of fraudulent misrepresentation (within the meaning of Section 12(f) of the Securities Act) shall be entitled to contribution from any person who was not guilty of such fraudulent misrepresentation.

4. Restriction on Transfer.

(a) Shareholder covenants and agrees that in any calendar quarter he will not offer to sell, sell or otherwise dispose of any amount of Registrable Securities in excess of one percent (1%) of the total number of shares of Common Stock then issued and outstanding.

(b) Notwithstanding the provisions of Section 4(a) of this Agreement, in the event that a Shareholder becomes liable for a payment obligation under the indemnification provisions of the Merger Agreement, Shareholder may, at his option, sell or pledge in accordance with the Registration Statement as then in effect or pursuant to an applicable exemption from registration, such number of shares of the Registrable Securities sufficient to generate net funds in the amount of that payment obligation.

5. Notices. Any notices or other communications required or permitted hereunder shall be in writing and shall be deemed duly given upon (a) confirmed delivery by a standard overnight carrier or when delivered by hand, or (b) the expiration of five business days after the day when mailed by certified or registered mail, postage prepaid, addressed at the following addresses (or at such other address as the parties hereto shall specify by like notice):

(x) If to the Company, to:

Chesapeake Utilities Corporation  
909 Silver Lake Boulevard  
Dover, Delaware 19904  
Attention: John R. Schimkaitis

with a copy to:

Covington & Burling  
1201 Pennsylvania Avenue, N.W.  
Post Office Box 7566  
Washington, D.C. 20044  
Attention: Ruth S. Epstein

(y) If to Shareholder, to the most recent address given by Shareholder to the Company, which address initially appears on below his signature.

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6. Miscellaneous. This Agreement and any term hereof may be changed, waived, discharged or terminated only by an instrument in writing, signed by the party against which enforcement of such change, waiver, discharge or termination is sought or by Shareholder and the Company. This Agreement shall be construed and enforced in accordance with and governed by the laws of the State of Delaware. The section headings in this Agreement are for purposes of convenience only and shall not constitute a part hereof.

IN WITNESS WHEREOF, the Company and Shareholder have caused this Agreement to be duly executed as of the date first above written.

CHESAPEAKE UTILITIES CORPORATION

By: \_\_\_\_\_

John R. Schimkaitis  
President

SHAREHOLDER

\_\_\_\_\_  
Name  
[address]

SCHMITTINGER AND RODRIGUEZ, P.A.

LAWYERS

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HAROLD SCHMITTINGER  
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PAUL H. BOSWELL  
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BRUCE C. ENNIS  
LARRY W. FIFER  
DOUGLAS B. CATTS  
WILLIAM D. FLETCHER, JR.  
WILLIAM A. DENMAN  
JAMES T. VAUGHN, JR.  
CATHERINE T. HICKEY  
WILLIAM W. PEPPER, SR.  
GREG T. ELIASSEN  
CRYSTAL L. CAREY\*  
SCOTT E. CHAMBERS\*  
MARDI F. PYOTT\*  
NOEL E. PRIMOS  
DAVID A. BOSWELL  
MICHELE L. PROCINO  
VICTOR F. SCHMITTINGER  
JEFFREY J. CLARK  
R. SCOTT KAPPEL  
KATHY S. GRAVELL\*  
\* ADMITTED IN MARYLAND

April 29, 1998

Delaware Public Service Commission  
Cannon Building, Suite 100  
861 Silver Lake Boulevard  
Dover, DE 19904

RE: Application of Chesapeake Utilities Corporation  
For The Approval of Issuance of Stock

Dear Commissioners:

We are Delaware counsel for Chesapeake Utilities Corporation ("Chesapeake") in connection with Chesapeake's application for Commission approval of the issuance of approximately 475,000 shares of Chesapeake common stock, pursuant to 26 Del. C. §215.

We are familiar with the terms, interpretation, and application of 26 Del. C. §215 which sets forth the required, but limited, findings to be made by the Commission in its consideration of such a proposed issue. We note the limited scope of Commission review, as determined by the Delaware Supreme Court in the Diamond State Telephone Company case, 367 A.2d 644 (1976). Specifically, in the Diamond State Telephone Company case, the Delaware Supreme Court held that the powers legislated to the Commission pursuant to 26 Del. C. §215 were intended to be applied in cases of a proposed issuance of stock for an inadequate consideration or for some other improper purpose. In Diamond State, the Delaware Supreme Court stated that in the absence of a showing of improper consideration, fraud, bad faith, or self-dealing on the part of the members of a utility's board of directors in their decision to issue shares of stock for the purpose of raising needed funds, it would be improper for the Commission to substitute its judgment for that of the board of directors.

Delaware Public Service Commission  
April 29, 1998  
Page 2

Based upon our knowledge of the applicable statute, and its regulatory and judicial interpretation and application, it is our opinion that the proposed issuance of approximately 475,000 shares of Chesapeake common stock has been duly authorized and is valid and in accordance with law, subject, of course, to the approval of the Public Service Commission pursuant to 26 Del. C. §215, any necessary approval on the part of the Florida Public Service Commission, and satisfactory compliance by Chesapeake with all applicable federal securities laws.

It is also our opinion, based upon the statement of Chesapeake's intended purpose for issuing said stock, that the subject stock issue is for a proper purpose, and is consistent with the public interest, by enabling Chesapeake to acquire Xeron, Inc.

Accordingly, it is our opinion that Chesapeake's pending application for Commission approval pursuant to 26 Del. C. §215 fully complies with the limited statutory requirements and findings necessary for Commission approval.

Sincerely yours,

SCHMITTINGER & RODRIGUEZ, P.A.

BY:

  
WILLIAM A. DENMAN, ESQUIRE

WAD:pmw

UNAUDITED

	ACTUAL BEFORE ISSUANCE	ADJUSTMENT 1/	PRO FORMA BEFORE ISSUANCE	ISSUANCE OF COMMON STOCK 2/	PRO FORMA AFTER ISSUANCE OF EQUITY
<b>ASSETS</b>					
<b>PROPERTY, PLANT AND EQUIPMENT</b>					
At original cost	\$143,345,126	\$750,746	\$144,095,872	\$170,700	\$144,266,572
Less: Accum. depreciation and amortization	(43,827,961)	(420,957)	(44,248,918)	(119,373)	(44,368,291)
Net property, plant and equipment	99,517,165	329,789	99,846,954	51,327	99,898,281
<b>INVESTMENTS</b>	2,721,443	0	2,721,443	0	2,721,443
<b>CURRENT ASSETS</b>					
Cash and cash equivalents	555,198	44,516	599,714	702,577	1,302,291
Accounts receivable, net	13,087,999	87,159	13,175,158	2,945,687	16,120,845
Materials and supplies	1,380,120	47,661	1,427,781	0	1,427,781
Propane inventory	2,288,516	0	2,288,516	101,333	2,389,849
Storage gas prepayments	2,926,618	0	2,926,618	0	2,926,618
Other prepaid expenses	1,910,534	7,268	1,917,802	313,802	2,231,604
Deferred income taxes	247,487	0	247,487	0	247,487
Underrecovered purchased gas costs	1,673,389	0	1,673,389	0	1,673,389
Total current assets	24,069,861	186,604	24,256,465	4,063,399	28,319,864
<b>DEFERRED CHARGES</b>					
Environmental regulatory assets	4,865,073	0	4,865,073	0	4,865,073
Environmental expenditures, net	2,372,929	0	2,372,929	0	2,372,929
Order 636 Transition cost	0	0	0	0	0
Other deferred charges & intangible assets	3,832,389	264,084	4,096,473	0	4,096,473
Total deferred charges & other assets	11,070,391	264,084	11,334,475	0	11,334,475
<b>TOTAL ASSETS</b>	<u>\$137,378,860</u>	<u>\$780,477</u>	<u>\$138,159,337</u>	<u>\$4,114,726</u>	<u>\$142,274,063</u>

UNAUDITED

LIABILITIES AND CAPITALIZATION	ACTUAL BEFORE ISSUANCE	ADJUSTMENT 1/	PRO FORMA BEFORE ISSUANCE	ISSUANCE OF COMMON STOCK 2/	PRO FORMA AFTER ISSUANCE OF EQUITY
<b>CAPITALIZATION</b>					
Common stock	\$2,191,792	\$12,168	\$2,203,960	\$231,183	\$2,435,142
Additional paid-in capital	19,819,604	38,833	19,858,437	(156,183)	19,702,254
Retained earnings	28,218,763	144,536	28,363,299	3,233,252	31,596,551
Less: Unearned compensation	(190,886)	0	(190,886)	0	(190,886)
Net unrealized gain on mkt. securities	296,872	0	296,872	0	296,872
Total stockholders' equity	50,336,145	195,536	50,531,681	3,308,252	53,839,933
<b>LONG-TERM DEBT, NET OF CURRENT</b>	38,226,000	0	38,226,000	0	38,226,000
<b>TOTAL CAPITALIZATION</b>	88,562,145	195,536	88,757,681	3,308,252	92,065,933
<b>CURRENT LIABILITIES</b>					
Current portion of long-term debt	582,500	0	582,500	0	582,500
Short-term borrowings	7,600,000	489,076	8,089,076	(3,256,925)	4,832,151
Accounts payable	12,451,570	80,633	12,532,203	3,388,814	15,921,017
Refunds payable to customers	357,041	0	357,041	0	357,041
Accrued interest	784,533	0	784,533	0	784,533
Overrecovered purchased gas costs	0	0	0	0	0
Dividends payable	1,092,168	0	1,092,168	0	1,092,168
Income taxes payable	0	0	0	0	0
Other accrued expenses	3,807,484	15,232	3,822,716	674,585	4,497,301
Total current liabilities	26,675,296	584,941	27,260,237	806,474	28,066,711
<b>DEFERRED CREDITS</b>					
Deferred income taxes	11,490,358	0	11,490,358	0	11,490,358
Deferred investment tax credits	821,617	0	821,617	0	821,617
Environmental liability	4,865,073	0	4,865,073	0	4,865,073
Accrued pension costs	1,754,715	0	1,754,715	0	1,754,715
Order 636 transition liability	0	0	0	0	0
Other liabilities	3,209,656	0	3,209,656	0	3,209,656
Total deferred credits and other liabilities	22,141,419	0	22,141,419	0	22,141,419
<b>TOTAL LIABILITIES AND CAPITALIZATION</b>	\$137,378,860	\$780,477	\$138,159,337	\$4,114,726	\$142,274,063

UNAUDITED

	ACTUAL BEFORE ISSUANCE	ADJUSTMENT 1/	PRO FORMA BEFORE ISSUANCE	ISSUANCE OF COMMON STOCK 2-5/	PRO FORMA AFTER ISSUANCE OF EQUITY
OPERATING REVENUES	\$122,774,593	\$1,539,638	\$124,314,231	\$127,451,157	\$251,765,388
OPERATING EXPENSES					
Purchased gas costs	77,764,830	0	77,764,830	125,505,822	203,270,652
Operations	21,831,194	1,223,093	23,054,287	1,148,185	24,202,472
Maintenance	2,041,043	73,643	2,114,686	0	2,114,686
Depreciation and amortization	5,396,975	61,496	5,458,471	9,950	5,468,421
Taxes-other than income	3,853,954	58,059	3,912,013	0	3,912,013
Taxes-income	3,327,627	38,331	3,365,958	267,648	3,633,606
Total Operating Expenses	114,215,623	1,454,622	115,670,245	126,931,605	242,601,850
NET OPERATING INCOME	8,558,970	85,016	8,643,986	519,552	9,163,538
OTHER INCOME AND DEDUCTIONS	427,711	1,290	429,001	378,129	807,130
INCOME BEFORE INTEREST CHARGES	8,986,681	86,306	9,072,987	897,681	9,970,668
INTEREST CHARGES					
Interest - Long-Term Debt	2,347,369	0	2,347,369	0	2,347,369
Interest - Short Term Borrowings	764,536	27,519	792,055	0	792,055
Interest - Other	157,574	0	157,574	0	157,574
Amortization of Debt Expense	119,401	0	119,401	0	119,401
Capital Leases	0	0	0	0	0
AFUDC	(85,145)	0	(85,145)	0	(85,145)
Total Interest Charges	3,303,735	27,519	3,331,254	0	3,331,254
TOTAL NET INCOME	\$5,682,946	\$58,787	\$5,741,733	\$897,681	\$6,639,414



The following adjustments have been made to the Income Statement and Balance Sheet for December 31, 1997:

- (1) The Adjustment column incorporates the financial impact from the Sam Shannahan Well Co., Inc. transaction with Chesapeake that was previously submitted to and approved by the Delaware Public Service Commission (Order No. 4758).
- (2) A reclass was made between Common stock and Additional paid-in capital for Xeron, Inc. so that the Common Stock amount would represent 475,000 shares of Chesapeake stock at a par value of \$.4867.
- (3) Average annual gross margin for the six year period (June 1, 1991-May 31, 1997) was used.
- (4) Compensation expense, including an amount associated with profit-sharing, has been adjusted to be consistent with the employment contracts.
- (5) Xeron, Inc. has excess cash of approximately \$3.26 million that Chesapeake would invest in its existing businesses to meet their capital requirements. The amount shown as other income represents the return on the cash available for investment in Chesapeake's other businesses, assuming Chesapeake's 1997 average return on equity of 11.61% (per the Annual Report). This would replace the interest income that Xeron, Inc. has historically earned on this cash.
- (6) Income taxes were calculated at a 34% tax rate, since Texas has no state income tax.

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# SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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## FORM 10-K

### ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Fiscal Year Ended: December 31, 1997      Commission File Number: 001-11590

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## CHESAPEAKE UTILITIES CORPORATION

(Exact name of registrant as specified in its charter)

State of Delaware  
(State or other jurisdiction of  
incorporation or organization)

51-0064146  
(I.R.S. Employer  
Identification No.)

909 Silver Lake Boulevard, Dover, Delaware  
(Address of principal executive offices)

19904  
(Zip Code)

Registrant's telephone number, including area code: 302-734-6799

Securities registered pursuant to Section 12(b) of the Act:

Title of each class  
Common Stock - par value per share \$.4867

Name of each exchange on which registered  
New York Stock Exchange, Inc.

Securities registered pursuant to Section 12(g) of the Act:

8.25% Convertible Debentures Due 2014  
(Title of class)

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendments to this Form 10-K. [X]

As of March 20, 1998, 4,543,695 shares of common stock were outstanding. The aggregate market value of the common shares held by non-affiliates of Chesapeake Utilities Corporation, based on the last trade price on March 20, 1997, as reported by the New York Stock Exchange, was approximately \$67 million.

#### DOCUMENTS INCORPORATED BY REFERENCE

DOCUMENTS  
Definitive Proxy Statement dated March 30, 1998

PART OF FORM 10-K  
Part III

**CHESAPEAKE UTILITIES CORPORATION**  
**FORM 10-K**

**Year Ended December 31, 1997**

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## PART I

### Item 1. Business

#### (a) General Development of Business

Chesapeake Utilities Corporation ("Chesapeake" or "the Company") is a diversified utility company engaged in natural gas distribution and transmission, propane distribution and advanced information services.

Chesapeake's three natural gas distribution divisions serve approximately 35,800 residential, commercial and industrial customers in southern Delaware, Maryland's Eastern Shore and Central Florida. The Company's natural gas transmission subsidiary, Eastern Shore Natural Gas Company ("Eastern Shore"), operates a 271-mile interstate pipeline system that transports gas from various points in Pennsylvania to the Company's Delaware and Maryland distribution divisions, as well as to other utilities and industrial customers in Delaware and on the Eastern Shore of Maryland. The Company's propane segment serves approximately 34,000 customers in southern Delaware and on the Eastern Shore of Maryland and Virginia. The advanced information services segment provides software services and products to a wide variety of customers and clients.

#### (b) Financial Information about Industry Segments

Financial information by business segment is included in Item 7 under the heading Notes to Consolidated Financial Statements.

#### (c) Narrative Description of Business

The Company is engaged in four primary business activities: natural gas transmission, natural gas distribution, propane distribution and advanced information services. In addition to the four primary groups, Chesapeake has three subsidiaries engaged in other service related businesses.

##### *(i) (a) Natural Gas Transmission*

Eastern Shore, the Company's wholly owned transmission subsidiary, operates an interstate natural gas transportation and provides contract storage services for affiliated and non-affiliated companies through an integrated gas pipeline extending from southeastern Pennsylvania to Delaware and the Eastern Shore of Maryland. During 1997, Eastern Shore implemented open access transportation services. Eastern Shore now provides transportation services, contract storage services as well as purchasing and selling small amounts of gas for system balancing purposes ("swing gas"). Eastern Shore's rates are subject to regulation by the Federal Energy Regulatory Commission ("FERC").

##### *Adequacy of Resources*

With the implementation of open access effective November 1, 1997, Eastern Shore released, through the permanent release mechanism of its upstream service providers tariffs, various levels of firm transportation capacity and contract storage service to customers. Eastern Shore retained contracts with Transcontinental Gas Pipe Line Corporation ("Transco") for 4,916 thousand cubic feet ("Mcf") firm transportation capacity, expiring in 2005, and three firm storage services providing peak day entitlements of 7,046 Mcf.

Eastern Shore also retained contracts with Columbia Gas Transportation ("Columbia") for services, including: firm transportation capacity of 869 Mcf per day, which expires in 2018; storage service providing a peak day entitlement of 1,111 Mcf and total capacity of 53,738 Mcf, expiring in 2004; and firm storage service providing peak day entitlements of 563 Mcf and a total capacity of 50,686 Mcf, which expires in 2018. Eastern Shore retained the firm transportation capacity to provide swing transportation service to a limited number of customers that requested this service. Prior to open access, Eastern Shore had firm contracts with three interstate pipelines for transportation and storage services coupled with firm contracts for natural gas supply with five suppliers providing a maximum firm daily capacity of 20,469 Mcf.

### ***Competition***

Under this open access environment, interstate pipeline companies have unbundled the traditional components of their service — gas gathering, transportation and storage — from the sale of the commodity. Pipelines that choose to be merchants of gas must form separate marketing operations independent of their pipeline operations. Hence, gas marketers have developed as a viable option for many companies because they are providing expertise in gas purchasing along with collective purchasing capabilities which, when combined, may reduce end-user cost. Additional discussion on competition is included in Item 7 under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations".

### ***Rates and Regulation***

General. Eastern Shore is subject to regulation by the FERC as an interstate pipeline. The FERC regulates the provision of service, terms and conditions of service, and the rates and fees Eastern Shore can charge to its transportation customers. In addition, the FERC regulates the rates Eastern Shore is charged for transportation and transmission line capacity and services provided by Transco and Columbia.

### ***Regulatory Proceedings***

Delaware City Compressor Station Filing. In December 1995, Eastern Shore filed an application before the FERC pursuant to Sections 7(b) and (c) of the Natural Gas Act for a certificate of public convenience and necessity authorizing Eastern Shore to: (1) construct and operate a 2,170 horsepower compressor station in Delaware City, New Castle County, Delaware on a portion of its existing pipeline system known as the "Hockessin Line", such new station to be known as the "Delaware City Compressor Station"; (2) construct and operate slightly less than one mile of 16-inch pipeline in Delaware City, New Castle County, Delaware to tie the suction side of the proposed Delaware City Compressor Station into the Hockessin Line; and (3) increase the maximum allowable operating pressure from 500 psig to 590 psig on 28.7 miles of Eastern Shore's pipeline from Eastern Shore's existing Bridgeville Compressor Station in Bridgeville, Sussex County, Delaware to its terminus in Salisbury, Wicomico County, Maryland.

In September 1996 the FERC issued its Final Order, which: (1) authorized Eastern Shore to construct and operate the facilities requested in its application; (2) authorized Eastern Shore to roll-in the cost of the facilities into its existing rates if the revenues from the increase in services exceed the cost associated with the expansion portion of the project; (3) denied Eastern Shore the authority to increase the level of sales and storage service it provides its customers until it completes its restructuring in its open access proceeding; and (4) authorized Eastern Shore to abandon the 100 Mcf per day of firm sale service, to one of its direct sale customers. The compressor facility and associated piping were needed to stabilize capacity on Eastern Shore's system as a result of steadily declining inlet pressures at the Hockessin interconnect with Transcontinental Gas Pipe Line Corporation. Construction of the facilities started during the second half of 1996 and was completed during the first quarter of 1997.

Rate Case Filing. In October 1996 Eastern Shore filed for a general rate increase with the FERC. The filing proposed an increase in Eastern Shore's jurisdictional rates that would generate additional annual operating revenue of approximately \$1.4 million. Eastern Shore also stated in the filing that it intended to use the cost-of-service submitted in the general rate increase filing to develop rates in the pending Open Access Docket. In September 1997, the FERC approved a rate increase of \$1.2 million.

Open Access Filing. In December 1995, Eastern Shore filed its abbreviated application for a blanket certificate of public convenience and necessity authorizing the transportation of natural gas on behalf of others. Eastern Shore proposed to unbundle the sales and storage services it had provided. Customers who had previously received firm sales and storage services on Eastern Shore (the "Converting Customers") would receive entitlements to firm transportation service on Eastern Shore's pipeline in a quantity equivalent to their existing service rights. Eastern Shore proposed to retain some of its pipeline entitlements and storage capacity for operational issues and to

facilitate "no-notice" (no prior notification required to receive service) transportation service on its pipeline system. Eastern Shore would release or assign to the remaining Converting Customers the firm transportation capacity, including contract storage, it held on its upstream pipelines so that the Converting Customers would be able to become direct customers of such upstream pipelines. Converting Customers who previously received bundled sales service having no-notice characteristics would have the right to elect no-notice firm transportation service.

In connection with the rate increase settlement, the issues pertaining to Eastern Shore operating as an open access pipeline were also settled in September 1997, with open access implementation occurring on November 1, 1997.

***(i) (b) Natural Gas Distribution***

Chesapeake distributes natural gas to approximately 35,800 residential, commercial and industrial customers in southern Delaware, the Salisbury and Cambridge, Maryland areas on Maryland's Eastern Shore, and Central Florida. These activities are conducted through three utility divisions, one division in Delaware, another in Maryland and a third division in Florida. In 1993, the Company started natural gas supply management services in the state of Florida under the name of Peninsula Energy Services Company ("PESCO").

Delaware and Maryland. The Delaware and Maryland divisions serve approximately 29,950 customers, of which approximately 26,860 are residential and commercial customers purchasing gas primarily for heating purposes. Annually, residential and commercial customers account for approximately 69% of the volume delivered by the divisions, and 79% of the divisions' revenue. The divisions' industrial customers purchase gas, primarily on an interruptible basis, for a variety of manufacturing, agricultural and other uses. Most of Chesapeake's customer growth in these divisions comes from new residential construction using gas heating equipment.

Florida. The Florida division distributes natural gas to approximately 8,748 residential and commercial and 84 industrial customers in Polk, Osceola and Hillsborough Counties. Currently 42 of the division's industrial customers, which purchase and transport gas on a firm and interruptible basis, account for approximately 90% of the volume delivered by the Florida division and 60% of the division's annual natural gas and transportation revenues. These customers are primarily engaged in the citrus and phosphate industries and electric cogeneration. The Company's Florida division also provides natural gas supply management services to compete in the open access environment. Currently, twenty-one customers receive such services, which generated gross margin of \$70,000 in 1997.

***Adequacy of Resources***

General. Chesapeake's Delaware and Maryland utility divisions ("Delaware", "Maryland" or "the Divisions") have firm and interruptible contracts with four (4) interstate "open access" pipelines. The Divisions are directly interconnected with Eastern Shore and services upstream of Eastern Shore are contracted with Transco, Columbia, and Columbia Gulf Transmission Company ("Gulf").

Delaware. Delaware's contracts with Transco include: (a) firm transportation capacity of 8,663 dekatherms ("Dt") per day, which expires in 2005; (b) firm transportation capacity of 311 Dt per day for December through February, expiring in 2006; and (c) firm storage service, providing a total capacity of 142,830 Dt, which expires in 1998.

Delaware's contracts with Columbia include: (a) firm transportation capacity of 852 Dt per day, which expires in 2004; (b) firm transportation capacity of 1,132 Dt per day, which expires in 2017; (c) firm storage service, providing a peak day entitlement of 6,193 Dt and a total capacity of 298,195 Dt, which expires in 2004; and (d) firm storage service providing a peak day entitlement of 635 Dt and a total capacity of 57,139 Dt, expiring in 2017. Delaware's contracts with Columbia for storage related transportation provide quantities that are equivalent to the peak day entitlement for the period of October through March and are equivalent to fifty percent (50%) of the peak

day entitlement for the period of April through September. The terms of the storage related transportation contracts mirror the storage services that they support.

Delaware's contract with Gulf, which expires in 2004, provides firm transportation capacity of 868 Dt per day for the period November through March and 798 Dt per day for the period April through October.

Delaware's contracts with Eastern Shore include: (a) firm transportation capacity of 23,494 Dt per day for the period December through February, 22,272 Dt per day for the months of November, March and April, and 13,196 Dt per day for the period May through October, with various expiration dates ranging from 2004 to 2017; (b) firm storage capacity under Eastern Shore's Rate Schedule GSS providing a peak day entitlement of 2,655 Dt and a total capacity of 131,370 Dt, which expires in 2013; (c) firm storage capacity under Eastern Shore's Rate Schedule LSS providing a peak day entitlement of 580 Dt and a total capacity of 29,000 Dt, which expires in 2013; and (d) firm storage capacity under Eastern Shore's Rate Schedule LGA providing a peak day entitlement of 911 Dt and a total capacity of 5,708 Dt, which expires in 2006. Delaware's firm transportation contracts with Eastern Shore also include Eastern Shore's provision of swing transportation service. This service includes: (a) firm transportation capacity of 1,846 Dt per day on Transco's pipeline system, retained by Eastern Shore, in addition to Delaware's Transco capacity referenced earlier and (b) an interruptible storage service under Transco's Rate Schedule ESS that supports a swing supply service provided under Transco's Rate Schedule FS.

Delaware currently has contracts for the purchase of firm natural gas supply with five (5) suppliers. These contracts provide the availability of a maximum firm daily entitlement of 10,958 Dt and the supplies are transported by Transco, Columbia, Gulf and Eastern Shore under Delaware's transportation contracts. The gas purchase contracts have various expiration dates.

Maryland Maryland's contracts with Transco include: (a) firm transportation capacity of 4,738 Dt per day, which expires in 2005; (b) firm transportation capacity of 155 Dt per day for December through February, expiring in 2006; and (c) firm storage service providing a total capacity of 33,120 Dt, which expires in 1998.

Maryland's contracts with Columbia include: (a) firm transportation capacity of 442 Dt per day, which expires in 2004; (b) firm transportation capacity of 908 Dt per day, which expires in 2017; (c) firm storage service providing a peak day entitlement of 3,142 Dt and a total capacity of 154,756 Dt, which expires in 2004; and (d) firm storage service providing a peak day entitlement of 521 Dt and a total capacity of 46,881 Dt, which expires in 2017. Maryland's contracts with Columbia for storage related transportation provide quantities that are equivalent to the peak day entitlement for the period October through March and are equivalent to fifty percent (50%) of the peak day entitlement for the period April through September. The terms of the storage related transportation contracts mirror the storage services that they support.

Maryland's contract with Gulf, which expires in 2004, provides firm transportation capacity of 590 Dt per day for the period November through March and 543 Dt per day for the period April through October.

Maryland's contracts with Eastern Shore include: (a) firm transportation capacity of 13,028 Dt per day for the period December through February, 12,304 Dt per day for the months of November, March and April, and 7,743 Dt per day for the period May through October; (b) firm storage capacity under Eastern Shore's Rate Schedule GSS providing a peak day entitlement of 1,428 Dt and a total capacity of 70,665 Dt, which expires in 2013; (c) firm storage capacity under Eastern Shore's Rate Schedule LSS providing a peak day entitlement of 309 Dt and a total capacity of 15,500 Dt, which expires in 2013; and (d) firm storage capacity under Eastern Shore's Rate Schedule LGA providing a peak day entitlement of 569 Dt and a total capacity of 3,560 Dt, which expires in 2006. Maryland's firm transportation contracts with Eastern Shore also include Eastern Shore's provision of swing transportation service. This service includes: (a) firm transportation capacity of 969 Dt per day on Transco's

pipeline system, retained by Eastern Shore, in addition to Maryland's Transco capacity referenced earlier and (b) an interruptible storage service under Transco's Rate Schedule ESS that supports a swing supply service provided under Transco's Rate Schedule FS.

Maryland currently has contracts for the purchase of firm natural gas supply with five (5) suppliers. These contracts provide the availability of a maximum firm daily entitlement of 6,243 Dt and the supplies are transported by Transco, Columbia, Gulf and Eastern Shore under Maryland's transportation contracts. The gas purchase contracts have various expiration dates. The Divisions use their firm supply sources to meet a significant percentage of their projected demand requirements. In order to meet the difference between firm supply and firm demand, Delaware and Maryland obtain gas supply on the "spot market" from various other suppliers that is transported by the upstream pipelines and delivered to the Divisions' interconnects with Eastern Shore as needed. The Company believes that Delaware and Maryland's available firm and "spot market" supply is ample to meet the anticipated needs of their customers.

Florida. The Florida division receives transportation service from Florida Gas Transmission Company ("FGT"), a major interstate pipeline. Chesapeake has contracts with FGT for: (a) daily firm transportation capacity of 20,523 Dt in May through September, 27,105 Dt in October, and 26,919 Dt in November through April under FGT's firm transportation service (FTS-1) rate schedule; (b) daily firm transportation capacity of 5,100 Dt in May through October, and 8,100 Dt in November through April under FGT's firm transportation service (FTS-2) rate schedule; and (c) daily interruptible transportation capacity of 20,000 Dt under FGT's interruptible transportation services (ITS-1) rate schedule. The firm transportation contract (FTS-1) expires on August 1, 2000 with the Company retaining a unilateral right to extend the term for an additional ten years. After the expiration of the primary or secondary term, Chesapeake has the right to first refuse to match the terms of any competing bids for the capacity. The firm transportation contract (FTS-2) expires on March 1, 2015. The interruptible transportation contract is effective until August 1, 2010 and month to month thereafter unless canceled by either party with thirty days notice.

The Florida division currently receives its gas supply from various suppliers. If needed, some supply is bought on the spot market; however, the majority is bought under the terms of two firm supply contracts with Natural Gas Clearinghouse and LG&E Energy Marketing. Availability of gas supply to the Florida division is also expected to be adequate under existing arrangements.

### **Competition**

Competition with Alternative Fuels. Historically, the Company's natural gas distribution divisions have successfully competed with other forms of energy such as electricity, oil and propane. The principal consideration in the competition between the Company and suppliers of other sources of energy is price and, to a lesser extent, accessibility. All of the Company's divisions have the capability of adjusting their interruptible rates to compete with alternative fuels.

The divisions have several large volume industrial customers that have the capacity to use fuel oil as an alternative to natural gas. When oil prices decline, these interruptible customers convert to oil to satisfy their fuel requirements. Lower levels in interruptible sales occur when oil prices remain depressed relative to the price of natural gas. However, oil prices as well as the prices of other fuels are subject to change at any time for a variety of reasons; therefore, there is always uncertainty in the continuing competition among natural gas and other fuels. In order to address this uncertainty, the Company uses flexible pricing arrangements on both the supply and sales side of its business to maximize sales volumes.

To a lesser extent than price, availability of equipment and operational efficiency are also factors in competition among fuels, primarily in residential and commercial settings. Heating, water heating and other domestic or



commercial equipment is generally designed for a particular energy source, and especially with respect to heating equipment, the cost of conversion is a disincentive for individuals and businesses to change their energy source.

*Competition within the Natural Gas Industry.* FERC Order 636 enables all natural gas suppliers to compete for customers on an equal footing. Under this open access environment, interstate pipeline companies have unbundled the traditional components of their service - gas gathering, transportation and storage from the sale of the commodity. If they choose to be a merchant of gas, they must form a separate marketing operation independent of their pipeline operations. Hence, gas marketers have developed as a viable option for many companies because they are providing expertise in gas purchasing along with collective purchasing capabilities which, when combined, may reduce end-user cost.

Also resulting from an open access environment, the distribution division can be in competition with the interstate transmission company if the distribution customer is located close to the transmission company's pipeline. The customers at risk are usually large volume commercial and industrial customers with the financial resources and capability to bypass the distribution division. In certain situations the distribution divisions may adjust rates and serves for these customers to retain their business.

### ***Rates and Regulation***

*General.* Chesapeake's natural gas distribution divisions are subject to regulation by the Delaware, Maryland and Florida Public Service Commissions with respect to various aspects of the Company's business, including the rates for sales to all of their customers in each jurisdiction. All of Chesapeake's firm distribution rates are subject to purchased gas adjustment clauses, which match revenues with gas costs and normally allow eventual full recovery of gas costs. Adjustments under these clauses require periodic filings and hearings with the relevant regulatory authority, but do not require a general rate proceeding. Rates on interruptible sales by the Florida division are also subject to purchased gas adjustment clauses.

Management monitors the rate of return in each jurisdiction in order to ensure the timely filing of rate adjustment applications.

### ***Regulatory Proceedings***

*Maryland.* In July 1995, Chesapeake's Maryland division filed an application with the Maryland Public Service Commission ("MPSC") requesting a rate increase of \$1,426,711 or 17.09%. The two largest components of the increase were attributable to environmental costs and a new customer information system, implemented in 1995.

On November 30, 1995, the MPSC issued an order approving a settlement proposal of a \$975,000 increase in annual base rates effective for gas provided on or after December 1, 1995. As required in the settlement of the rate case, the Company filed a cost of service study with the MPSC in June 1996. The purpose of a cost of service study was to allocate revenue among customer or rate classifications. The filing, which included proposals for restructuring sales services that more closely reflect the cost of serving commercial and industrial customers, the unbundling of gas costs from distribution system costs, revisions to sharing of interruptible margins between firm ratepayers and the Company and new services that would allow customers using more than 30,000 Ccf of gas per year to purchase gas from suppliers other than the Company.

After negotiations with MPSC staff and other interested parties, a settlement was reached on most sales service issues and the Commission approved a proposed order in March 1997. The settlement includes: (1) class revenue requirements and restructured sales services which provide for separate firm commercial and industrial rate schedules for general service, medium volume, large volume and high load factor customer groups; (2) unbundling of gas costs from distribution charges; (3) a new gas cost recovery mechanism, which utilizes a projected period under which the fixed cost portion of the gas rate will be forecasted on an annual basis and the commodity cost

portion of the gas rate will be estimated quarterly, based on projected market prices; and (4) interruptible margins will continue to be shared, 90% to customers and 10% to the Company, but distribution costs incurred for incremental load additions can be recovered with carrying charges utilizing 100% of the incremental margin if the payback period is within three years.

At the request of MPSC staff, consideration of the new transportation services were postponed until Eastern Shore's open access filing was settled with the FERC.

Delaware. In April 1995, Chesapeake's Delaware division filed an application with the Delaware Public Service Commission ("DPSC") requesting a rate increase of \$2,751,000 or 14% over current rates. The largest component, one-third of the total requested increase, was attributable to projected costs associated with the remediation proposed by the Environmental Protection Agency ("EPA") of the site of a former coal gas manufacturing plant operated in Dover, Delaware. The Company and the DPSC agreed to separate the environmental recovery from the rate increase so each could be addressed individually. In December 1995, the DPSC approved an order authorizing a \$900,000 increase to base rates effective January 1, 1996.

In December 1995, the DPSC approved a recovery of environmental costs associated with the Dover Gas Light Site by means of a rider (supplement) to base rates. The DPSC approved a rider effective January 1, 1996 to recover over five years all unrecovered environmental costs through September 30, 1995 offset by the deferred tax benefit of these costs. The deferred tax benefit equals the projected cashflow savings realized by the Company in connection with a reduced income tax liability due to the possibility of accelerated deduction allowed on certain environmental costs when incurred. Each year, the rider rate will be calculated based on the amortization of expenses for previous years. The advantage of the environmental rider is that it is not necessary to file a rate case every year to recover expenses.

In December 1995, Chesapeake's Delaware division filed its rate design proposal with the DPSC to initiate Phase II of this proceeding. The principal objective of the filing was to prepare the Company for an increasingly competitive environment anticipated when Eastern Shore becomes an open access pipeline. This initial filing proposed new rate schedules for commercial and industrial sales service, individual pricing for interruptible negotiated contract rates, a modified purchased gas cost recovery mechanism and a natural gas vehicle tariff.

In May 1996, Delaware division filed its proposal relating to transportation and balancing services with the DPSC, which proposed that transportation of customer-owned gas be available to all commercial and industrial customers with annual consumption over 3,000 Mcf per year.

In February 1997, the DPSC approved an order authorizing new service offerings and rate design for services rendered on and after March 1, 1997. The approved changes include: (1) restructured sales services which provide commercial and industrial customers with various service classifications such as general service, medium volume, large volume and high load factor services; (2) a modified purchased gas cost recovery mechanism which takes into consideration the unbundling of gas costs from distribution charges as well as charging certain firm service classifications different gas cost rates based on the service classification's load factor; (3) the implementation of a mechanism for sharing interruptible, capacity release and off-system sales margins between firm sales customers and the Company, with changing margin sharing percentages based on the level of total margin; and (4) a provision for transportation and balancing services for commercial and industrial customers with annual consumption over 30,000 Ccf per year to transport customer-owned gas on the Company's distribution system.

Florida. On November 26, 1997, the Florida Division filed a request with the Florida Public Service Commission (FPSC) in Docket No. 971559-GU, for a Limited Proceeding to Restructure Rates and for Approval of Gas Transportation Agreements. The Florida Division has entered into Gas Transportation Contracts with its two largest

customers which resulted in retaining these two customers on the Company's distribution system at rates lower than previously achieved. As a result of this reduction in revenue, the Company has proposed in its application to restructure rates for its remaining customers to more closely reflect the cost of service for each rate class and to recover the level of revenues previously generated by the two Contract customers.

The Company's restructuring proposal is revenue neutral. Approval of this request would not result in additional revenues to the Company; however, FPSC approval would enable the Company to retain its two largest customers while providing the Company with the opportunity to achieve its FPSC authorized rate of return.

FPSC Staff issued their recommendation in this docket on March 12, 1998. The Commission voted to approve the Company's restructuring proposal on March 24, 1998. A Commission Order in this docket is expected April 14, 1998.

#### ***(i) (c) Propane Distribution***

Chesapeake's propane distribution group consists of Sharp Energy, Inc. ("Sharp Energy"), a wholly owned subsidiary of Chesapeake, its wholly owned subsidiary, Sharpgas, Inc. ("Sharpgas") and Tri-County Gas Company, Inc. ("Tri-County") a wholly owned subsidiary of Chesapeake.

On March 6, 1997, Chesapeake acquired all of the outstanding shares of Tri-County a family-owned and operated propane distribution business located in Salisbury and Pocomoke, Maryland. The combined operations of the Company and Tri-County served approximately 34,000 propane customers on the Delmarva Peninsula and delivered approximately 27 million retail and wholesale gallons of propane during 1997.

The propane distribution business is affected by many factors such as seasonality, the absence of price regulation and competition among local providers.

Propane is a form of liquefied petroleum gas which is typically extracted from natural gas or separated during the crude oil refining process. Although propane is gaseous at normal pressures, it is easily compressed into liquid form for storage and transportation. Propane is a clean-burning fuel, gaining increased recognition for its environmental superiority, safety, efficiency, transportability and ease of use relative to alternative forms of energy. Propane is sold primarily in suburban and rural areas which are not served by natural gas pipelines. Demand is typically much higher in the winter months and is significantly affected by seasonal variations, particularly the relative severity of winter temperatures, because of its use in residential and commercial heating.

#### ***Adequacy of Resources***

Sharp Energy and Tri-County purchase propane primarily from suppliers, including major domestic oil companies and independent producers of gas liquids and oil. Supplies of propane from these and other sources are readily available for purchase by the Company. Supply contracts generally include minimum (not subject to a take-or-pay premiums) and maximum purchase provisions.

Sharp Energy and Tri-County use trucks and railroad cars to transport propane from refineries, natural gas processing plants or pipeline terminals to the Company's bulk storage facilities. From these facilities, propane is delivered in portable cylinders or by "bobtail" trucks, owned and operated by the Companies, to tanks located at the customer's premises.

#### ***Competition***

Sharp Energy and Tri-County 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 local because distributors located in close proximity to customers incur lower costs of providing service.

Propane competes with both fuel oil and electricity as an energy source. Propane competes with fuel oil based on its cleanliness and environmental advantages. Propane is also typically less expensive than both fuel oil and electricity, based on equivalent BTU value. Since natural gas has historically been less expensive than propane, propane is generally not distributed in geographic areas serviced by natural gas pipeline or distribution systems.

The Company's propane distribution activities are not subject to any federal or state pricing regulation. Transport operations are subject to regulations concerning the transportation of hazardous materials promulgated under the Federal Motor Carrier Safety Act, which is administered by the United States Department of Transportation and enforced by the various states in which such operations take place. Propane distribution operations are also subject to state safety regulations relating to "hook-up" and placement of propane tanks.

The Company's propane operations are subject to all operating hazards normally associated with the handling, storage and transportation of combustible liquids, such as the risk of personal injury and property damage caused by fire. The Company carries general liability insurance in the amount of \$35,000,000 per occurrence, but there is no assurance that such insurance will be adequate.

***(l) (d) Advanced Information Services***

Chesapeake's advanced information services segment is comprised of United Systems, Inc. ("USI") and Capital Data Systems, Inc. ("CDS"), both wholly owned subsidiaries of the Company. CDS provided programming support for application software, until the first quarter of 1997, at which time it disposed of substantially all of its assets.

USI is an Atlanta-based company that primarily provides support for users of PROGRESS™, a fourth generation computer language and Relational Database Management System. USI offers consulting, training, software development "tools" and customer software development for its client base, which includes many large domestic and international corporations.

***Competition***

The advanced information services businesses face significant competition from a number of larger competitors having substantially greater resources available to them than the Company. In addition, changes in the advanced information services businesses are occurring rapidly, which could adversely impact the markets for the Company's products and services.

***(l) (e) Other Subsidiaries***

Skipjack, Inc. ("Skipjack") and Chesapeake Investment Company ("Chesapeake Investment"), are wholly owned subsidiaries of Chesapeake Service Company. Skipjack owns and leases to affiliates, two office buildings in Dover, Delaware. Chesapeake Investment is a Delaware affiliated investment company.

On March 6, 1997, in connection with the acquisition of Tri-County, the Company acquired Eastern Shore Real Estate, Inc. ("ESR"), which became a wholly owned subsidiary of Chesapeake Service Company. ESR owns and leases office buildings to affiliates and external companies.

***(ii) Seasonal Nature of Business***

Revenues from the Company's residential and commercial natural gas sales and from its propane distribution activities are affected by seasonal variations, since the majority of these sales are to customers using the fuels for heating purposes. Revenues from these customers are accordingly affected by the mildness or severity of the heating season.

**(iii) Capital Budget**

A discussion of capital expenditures by business segment is included in Item 7 under the heading "Liquidity and Capital Resources".

**(iv) Employees**

The Company has 397 employees, including 114 in natural gas distribution, nine in natural gas transmission, 131 in propane distribution and 63 in advanced information services. The remaining 80 employees are considered general and administrative and include officers of the Company and marketing, engineering, treasury, accounting, data processing, planning, human resources and other administrative personnel. The acquisition of Tri-County added 43 employees to the total number of employees of the Company.

**Item 2. Properties**

**(a) General**

The Company owns offices and operates facilities in Pocomoke, Salisbury, Cambridge, and Princess Anne, Maryland; Dover, Seaford, Laurel and Georgetown, Delaware; and Winter Haven, Florida, and rents office space in Dover, Delaware; Plant City, Florida; Chincoteague and Belle Haven, Virginia; Easton and Pocomoke, Maryland; Detroit, Michigan; and Atlanta, Georgia. In general, the properties of the Company are adequate for the uses for which they are employed. Capacity and utilization of the Company's facilities can vary significantly due to the seasonal nature of the natural gas and propane distribution businesses.

**(b) Natural Gas Distribution**

Chesapeake owns over 542 miles of natural gas distribution mains (together with related service lines, meters and regulators) located in its Delaware and Maryland service areas, and 469 miles of such mains (and related equipment) in its Central Florida service areas. Chesapeake also owns facilities in Delaware and Maryland for propane-air injection during periods of peak demand. A portion of the properties constituting Chesapeake's distribution system are encumbered pursuant to Chesapeake's First Mortgage Bonds.

**(c) Natural Gas Transmission**

Eastern Shore owns approximately 271 miles of transmission lines extending from Parkesburg, Pennsylvania to Salisbury, Maryland. Eastern Shore also owns three compressor stations located in Delaware City, Delaware, Daleville, Pennsylvania and Bridgeville, Delaware. The Delaware City compressor facility and associated piping are needed to stabilize capacity on Eastern Shore's system as a result of steadily declining inlet pressures at the Hockessin interconnect with Transcontinental Gas Pipe Line Corporation. The Daleville station is used to increase Columbia supply pressures to match Transco supply pressures, and to increase Eastern Shore's pressures in order to serve Eastern Shore's firm customers' demands, including those of Chesapeake's Delaware and Maryland divisions. The Bridgeville station is being used to provide increased pressures required to meet demands on the system.

**(d) Propane Distribution**

Sharpgas and Tri-County own bulk propane storage facilities with an aggregate capacity of 1.9 million gallons at 33 plant facilities in Delaware, Maryland and Virginia, located on real estate they either own or lease.

**Item 3. Legal Proceedings**

The Company and its subsidiaries are 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 of the Company.

## **Environmental**

### **(a) Dover Gas Light Site**

In 1984, the State of Delaware notified the Company that a parcel of land it purchased in 1949 from Dover Gas Light Company, a predecessor gas company, contained hazardous substances. The State also asserted that the Company is responsible for any clean-up and prospective environmental monitoring of the site. The Delaware Department of Natural Resources and Environmental Control ("DNREC") investigated the site and surroundings, finding coal tar residue and some ground-water contamination.

In October 1989, the Environmental Protection Agency Region III ("EPA") listed the Dover Site on the National Priorities List under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA" or "Superfund"). At that time under CERCLA, both the State of Delaware and the Company were named as potentially responsible parties ("PRPs") for clean-up of the site.

The EPA issued the site Record of Decision ("ROD") dated August 16, 1994. The remedial action selected by the EPA in the ROD addressed the ground-water contamination with a combination of hydraulic containment and natural attenuation. Remediation selected for the soil at the site was to meet stringent cleanup standards for the first two feet of soil and less stringent standards for the soil below two feet. The ROD estimated the costs of selected remediation of ground-water and soil at \$2.7 million and \$3.3 million, respectively.

In May 1995, EPA issued an order to the Company under section 106 of CERCLA (the "Order"), which required the Company to fund or implement the ROD. The Order was also issued to General Public Utilities Corporation, Inc. ("GPU"), which both EPA and the Company believe is liable under CERCLA. Other PRPs such as the State of Delaware were not ordered to perform the ROD. EPA may seek judicial enforcement of its Order, as well as significant financial penalties for failure to comply. Although notifying EPA of objections to the Order, the Company agreed to comply. GPU informed EPA that it did not intend to comply with the Order.

In March 1995, the Company commenced litigation against the State of Delaware for contribution to the remedial costs being incurred to carry out the ROD. In December of 1995, this case was dismissed without prejudice based on a settlement agreement between the parties (the "Settlement"). Under the Settlement, the State agreed to support the Company's proposal to reduce the soil remedy for the site, described below, to contribute \$600,000 toward the cost of implementing the ROD and to reimburse the EPA for \$400,000 in oversight costs. The Settlement is contingent upon a formal settlement agreement between EPA and the State of Delaware. Upon satisfaction of all conditions of the Settlement, the litigation will be dismissed with prejudice.

In June 1996, the Company initiated litigation against GPU for contribution to the remedial costs incurred by Chesapeake in connection with complying with the ROD. At this time, management cannot predict the outcome of the litigation or the amount, if any, of proceeds to be received.

In July 1996, the Company began the design phase of the ROD, on-site pre-design and investigation. A pre-design investigation report ("the report") was filed in October 1996 with the EPA. The report, which required EPA approval, provided up to date status on the site, which the EPA used to determine if the remedial design selected in the ROD was still the appropriate remedy.

In the report, the Company proposed a modification to the soil clean-up remedy selected in the ROD to take into account an existing land use restriction banning future development at the site. In April of 1997, the EPA issued a fact sheet stating that the EPA was considering the proposed modification. The fact sheet included an overall cost estimate of \$5.7 million for the proposed modified remedy and a new overall cost estimate of \$13.2 million for the remedy selected in the ROD. On August 28, 1997, the EPA issued a Proposed Plan to modify the current clean-up plan that would involve: (1) excavation of off-site thermal treatment of the contents of the former subsurface gas holders; (2) implementation

of soil vaporization extraction; (3) pavement of the parking lot; and (4) use of institutional controls that would restrict future development of the Site. The overall estimated clean-up cost of the Site under the proposed plan was \$4.2 million, as compared to EPA's estimate of the current clean-up plan at \$13.2 million. In January 1998, the EPA issued a revised ROD, which modified the soil remediation to conform to the proposed plan and included the estimated clean-up costs of \$4.2 million.

The Company is currently engaged in investigations related to additional parties who may be PRPs. Based upon these investigations, the Company will consider suit against other PRPs. The Company expects continued negotiations with PRPs in an attempt to resolve these matters.

The Company adjusted its accrued liability recorded with respect to the Dover Site to \$4.2 million. This amount reflects the EPA's estimate, as stated in the ROD issued in 1998 for remediation of the site according to the ROD. The recorded liability may be adjusted upward or downward as the design phase progresses and the Company obtains construction bids for performance of the work. The Company has also recorded a regulatory asset of \$4.2 million, corresponding to the recorded liability. Management believes that in addition to the \$600,000 expected to be contributed by the State of Delaware under the Settlement, the Company will be equitably entitled to contribution from other responsible parties for a portion of the expenses to be incurred in connection with the remedies selected in the ROD. Management also believes that the amounts not so contributed will be recoverable in the Company's rates.

As of December 31, 1997, the Company has incurred approximately \$5.0 million in costs relating to environmental testing and remedial action studies. In 1990, the Company entered into settlement agreements with a number of insurance companies resulting in proceeds to fund actual environmental costs incurred over a five to seven-year period. In December 1995, the Delaware Public Service Commission, authorized recovery of all unrecovered environmental cost incurred by a means of a rider (supplement) to base rates, applicable to all firm service customers. The costs would be recovered through a five-year amortization offset by the deferred tax benefit associated with those environmental costs. The deferred tax benefit equals the projected cashflow savings realized by the Company in connection with a reduced income tax liability due to the possibility of accelerated deduction allowed on certain environmental costs when incurred. Each year a new rider rate is calculated to become effective December 1. The rider rate is based on the amortization of expenditures through September of the filing years plus amortization of expenses from previous years. The advantage of the rider is that it is not necessary to file a rate case every year to recover expenses incurred. As of December 31, 1997, the unamortized balance and amount of environmental costs not included in the rider, effective January 1, 1998 was \$2.1 million and \$190,000, respectively. With the rider mechanism established, it is management's opinion that these costs and any future cost, net of the deferred income tax benefit, will be recoverable in rates.

#### **(b) Salisbury Town Gas Light Site**

In cooperation with the Maryland Department of the Environment ("MDE"), the Company has completed assessment, construction and has begun remediation of the Salisbury manufactured gas plant site. The assessment determined that there was localized contamination of ground-water. A remedial design report was submitted to MDE in November 1990 and included a proposal to monitor, pump and treat any contaminated ground-water on-site. Through negotiations with the MDE, the remedial action work plan was revised with final approval from MDE obtained in early 1995. The remediation process for ground-water was revised from pump-and-treat to Air Sparging and Soil-Vapor Extraction, resulting in a substantial reduction in overall costs. During 1996, the Company completed construction and began remediation procedures at the Salisbury site and has been reporting the remediation and monitoring results to the Maryland Department of the Environment on an ongoing basis.

The cost of remediation is estimated to range from \$140,000 to \$190,000 per year for operating expenses. Based on these estimated costs, the Company recorded both a liability and a deferred regulatory asset of \$665,000 on December 31, 1997, to cover the Company's projected remediation costs for this site. The liability payout for this site is expected to be over a five-year period. As of December 31, 1997, the Company has incurred approximately \$2.4 million for

remedial actions and environmental studies and has charged such costs to accumulated depreciation. In January 1990, the Company entered into settlement agreements with a number of insurance companies resulting in proceeds to fund actual environmental costs incurred over a three to five-year period beginning in 1990. The final insurance proceeds were requested and received in 1992. In December 1995, the Maryland Public Service Commission approved recovery of all environmental cost incurred through September 30, 1995 less amounts previously amortized and insurance proceeds. The amount approved for a 10-year amortization was \$964,251. Of the \$2.4 million in costs reported above, approximately \$597,000 has not been recovered through insurance proceeds or received ratemaking treatment. It is management's opinion that these costs incurred and future costs incurred, if any, will be recoverable in rates.

#### **(c) Winter Haven Coal Gas Site**

In May 1996, the Company filed an Air Sparging and Soil Vapor Extraction Pilot Study Work Plan for the Winter Haven site with the Florida Department of Environmental Protection ("FDEP"). The Work Plan described the Company's proposal to undertake an Air Sparging and Soil Vapor Extraction ("AS/SVE") pilot study to evaluate at the site. After discussions with the FDEP, the Company filed a modified AS/SVE Pilot Study Work Plan, scope of work to complete the site assessment activities and a report describing a limited sediment investigation performed recently. The Company will be awaiting FDEP's comments to the modified Work Plan. It is not possible to determine whether remedial action will be required by FDEP and, if so, the cost of such remediation.

The company has spent and received ratemaking treatment of approximately \$678,000 on these investigations as of September 30, 1997. The Company has been allowed by the Florida Public Service Commission to continue to accrue for future environmental costs. At September 30, 1997, the Company had \$432,000 accrued. It is management's opinion that future costs, if any, will be recoverable in rates.

#### **Item 4. Submission of Matters to a Vote of Security Holders**

None

#### **Item 10. Executive Officers of the Registrant**

Information pertaining to the Executive Officers of the Company is as follows:

Ralph J. Adkins (age 55) Mr. Adkins is Chairman of the Board and Chief Executive Officer of Chesapeake. He has served as Chairman of the Board and Chief Executive Officer since August 1997. Prior to holding his present position, Mr. Adkins served as President and Chief Executive Officer, President and Chief Operating Officer, Executive Vice President, Senior Vice President, Vice President and Treasurer of Chesapeake. Mr. Adkins is also Chairman and Chief Executive Officer of Chesapeake Service Company, and Chairman and Chief Executive Officer of Sharp Energy, Inc., Tri-County Gas Company, Inc., Chesapeake Service Company and Eastern Shore Natural Gas Company, all wholly owned subsidiaries of Chesapeake. He has been a director of Chesapeake since 1989.

John R. Schimkaitis (age 50) Mr. Schimkaitis is President and Chief Operating Officer. He has served as President since August 1997. He previously served as Executive Vice President, Chief Financial Officer, Senior Vice President, Treasurer and Assistant Secretary. From 1983 to 1986, Mr. Schimkaitis was Vice President of Cooper & Rutter, Inc., a consulting firm providing financial services to the utility and cable industries. He was appointed as a director of Chesapeake in February 1996.

Michael P. McMasters (age 39) Mr. McMasters is Vice President, Chief Financial Officer and Treasurer of Chesapeake Utilities Corporation. He has served as Vice President, Chief Financial Officer and Treasurer since December 1996. He previously served as Vice President of Eastern Shore, Director of Accounting and Rates and Controller. From 1992 to May 1994, Mr. McMasters was employed as Director of Operations Planning for Equitable Gas Company.



Stephen C. Thompson (age 37) Mr. Thompson is Vice President of the Natural Gas Operations, as well as Vice President of Chesapeake Utilities Corporation. He has served as Vice President since May 1997. He has served as President, Vice President, Manager, Director of Gas Supply and Marketing and Superintendent of Eastern Shore and Regional Manager for the Florida distribution Operations.

Philip S. Barefoot (age 50) Mr. Barefoot joined Chesapeake as Division Manager of Florida Operations in July 1988. In May 1994 he was elected Vice President of Chesapeake Utilities Corporation. Prior to joining Chesapeake, he was employed by Peoples Natural Gas Company where he held the positions of Division Sales Manager, Division Manager and Vice President of Florence Operations.

Jeremy D. West (age 48) Mr. West joined Chesapeake as President of Sharp Energy in June 1990. In May 1992 he was elected Vice President of Chesapeake's Propane Operations and in May 1997, he was promoted to Vice President of Strategic Planning and Acquisitions. Prior to joining Chesapeake, he was employed by Columbia Propane Corporation, a subsidiary of Columbia Gas System, as Vice President of Marketing, and later, President of Columbia Propane Corporation. He has also serviced as Regional Manager of Suburban Propane.

## PART II

### Item 5. Market for the Registrant's Common Stock and Related Security Holder Matters

#### (a) Common Stock Dividends and Price Ranges:

The following table sets forth sale price and dividend information for each calendar quarter during the years December 31, 1997 and 1996:

Quarter Ended	High	Low	Close	Dividends Declared Per Share
<b>1997</b>				
March 31.....	\$18.000	\$16.500	\$17.375	\$0.2425
June 30.....	17.500	16.000	17.000	0.2425
September 30.....	18.500	16.250	18.375	0.2425
December 31.....	21.750	18.375	20.500	0.2425
<b>1996</b>				
March 31.....	\$17.000	\$14.500	\$16.750	\$0.2325
June 30.....	17.875	15.875	16.000	0.2325
September 30.....	17.750	15.125	17.500	0.2325
December 31.....	18.000	16.375	16.875	0.2325

The common stock of the Company trades on the New York Stock Exchange under the symbol "CPK".

#### (b) Approximate number of holders of common stock as of December 31, 1997:

<u>Title of Class</u>	<u>Number of Shareholders of Record</u>
Common stock, par value \$.4867	2,178

**(c) Dividends:**

During the years ended December 31, 1997 and 1996, cash dividends paid by Chesapeake have been declared each quarter, in the amounts set forth in the table above. During 1996 and 1995, Tri-County paid dividends of \$79,000 and \$592,000, respectively.

Indentures to the long-term debt of the Company and its subsidiaries contain a restriction that the Company cannot, until the retirement of its Series I Bonds, pay any dividends after December 31, 1988 which exceed the sum of \$2,135,188 plus consolidated net income recognized on or after January 1, 1989. As of December 31, 1997, the amounts available for future dividends permitted by the Series I covenant are \$14.6 million.

(d) On March 6, 1997, in conjunction with the acquisition of Tri-County Gas Company, Inc., the Company issued 639,000 shares of Company stock to William P. Schneider and James R. Schneider in reliance on the private placement exemption provided by Section 4(2) of the Securities Act of 1933 and Regulation D, thereunder.

# Item 6. Selected Financial Data

For the Years Ended December 31,	(dollars in thousands except stock data)				
	1997	1996	1995	1994 (1)	1993 (1)
<b>Operating</b>					
Operating revenues	\$122,775	\$130,213	\$111,796	\$98,572	\$85,873
Operating income	\$8,559	\$10,110	\$10,067	\$7,227	\$6,311
Income before cumulative effect of change in accounting principle	\$5,683	\$7,605	\$7,594	\$4,460	\$3,914
Cumulative effect of change in accounting principle					\$58
Net income	\$5,683	\$7,605	\$7,594	\$4,460	\$3,972
<b>Balance Sheet</b>					
Gross plant	\$143,345	\$133,001	\$119,837	\$110,023	\$100,330
Net plant	\$99,517	\$93,570	\$84,589	\$75,313	\$69,794
Total assets	\$137,379	\$136,046	\$123,339	\$108,271	\$100,988
Long-term debt, net	\$38,226	\$28,984	\$31,619	\$24,329	\$25,682
Common stockholders' equity	\$50,336	\$47,537	\$42,582	\$37,063	\$34,878
Capital expenditures	\$11,381	\$14,837	\$12,887	\$10,653	\$10,064
<b>Common Stock</b>					
Basic earnings per share:					
Income before cumulative effect of change in accounting principle	\$1.27	\$1.72	\$1.75	\$1.23	\$1.10
Cumulative effect of change in accounting principle					\$0.02
Net income	\$1.27	\$1.72	\$1.75	\$1.23	\$1.12
Diluted earnings per share:					
Income before cumulative effect of change in accounting principle	\$1.24	\$1.67	\$1.70	\$1.20	\$1.08
Cumulative effect of change in accounting principle					\$0.02
Net income	\$1.24	\$1.67	\$1.70	\$1.20	\$1.10
Average shares outstanding	4,472,087	4,412,137	4,336,431	3,628,056	3,551,932
Cash dividends per share	\$0.97	\$0.93	\$0.90	\$0.88	\$0.86
Book value per share	\$11.18	\$10.71	\$9.77	\$10.15	\$9.76
Common equity/Total capitalization	56.80%	62.10%	57.40%	60.37%	57.59%
Return on equity	11.29%	16.00%	17.80%	- 12.03%	11.39%
<b>Other</b>					
Number of Employees	397	386	383	320	326
Number of Registered Stockholders	2,178	2,213	2,098	1,721	1,743
Heating Degree Days	4,418	4,717	4,593	4,398	4,705
Heating Degree Days (10-year average)	4,577	4,596	4,586	4,564	4,588

(1) 1994 and 1993 have not been restated to include the business combination with Tri-County Gas Company, Inc.

## **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### **Liquidity and Capital Resources**

The capital requirements of Chesapeake Utilities Corporation ("Chesapeake" or "the Company") reflect the capital-intensive nature of its business and are attributable principally to the construction program and the retirement of outstanding debt. The Company relies on cash generated from operations and short-term borrowing to meet normal working capital requirements and temporarily finance capital expenditures. During 1997, net cash provided by operating activities, used by investing activities and used by financing activities were \$12.3 million, \$12.4 million and \$1.5 million, respectively.

The Board of Directors has authorized the Company to borrow up to \$20.0 million from various banks and trust companies. As of December 31, 1997, Chesapeake had four unsecured bank lines of credit, totaling \$34.0 million, for short-term cash needs to meet seasonal working capital requirements and to temporarily fund portions of its capital expenditures. The outstanding balances of short-term borrowing at December 31, 1997 and 1996 were \$7.6 million and \$12.7 million, respectively.

In 1997, Chesapeake used cash provided by operations and the issuance of long-term debt to fund capital expenditures and reduce short-term borrowing. During 1996, the Company used cash provided by operating activities and short-term borrowing to fund the capital expenditures and increases in working capital requirements.

During 1997, 1996 and 1995, capital expenditures were approximately \$12.8 million, \$14.8 million and \$12.9 million, respectively. Chesapeake has budgeted \$15.6 million for capital expenditures during 1998. This amount includes \$8.7 million and \$2.7 million for natural gas and propane distribution, respectively; \$3.1 million for natural gas transmission, \$395,000 for advanced information services and \$632,000 for general plant. The natural gas and propane distribution expenditures are for expansion and improvement of facilities in existing service territories. Natural gas transmission expenditures are for improvement and expansion of the pipeline system. The advanced information services expenditures are for computer hardware, software and related equipment. Financing for the 1998 construction program is expected to be provided from short-term borrowing and cash from operations. The construction program is subject to continuous review and modification. Actual construction expenditures may vary from the above estimates due to a number of factors including inflation, changing economic conditions, regulation, sales growth and the cost and availability of capital.

Chesapeake has budgeted \$2.8 million for environmental related expenditures during 1998 and expects to incur additional expenditures in future years (see Note J to the Consolidated Financial Statements), a portion of which may need to be financed through external sources. Management does not expect such financing to have a material adverse effect on the financial position or capital resources of the Company.

### **Capital Structure**

As of December 31, 1997, common equity represented 56.8% of permanent capitalization compared to 62.1% in 1996 and 57.4% in 1995. 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, helps to ensure that Chesapeake will be able to attract capital from outside sources at a reasonable cost. The achievement of these objectives will provide benefits to customers and creditors, as well as to the Company's investors.

### **Financing Activities**

In December 1997, Chesapeake finalized a private placement of \$10 million of 6.85% Senior Notes due January 1, 2012. The Company used the proceeds to repay a portion of its short-term borrowing. In October 1995, the Company finalized a private placement of \$10 million of 6.91% Senior Notes due in 2010. The Company used the proceeds to retire \$4.1

million of the 10.85% Senior Notes of Eastern Shore Natural Gas Company, the Company's natural gas transmission subsidiary ("Eastern Shore") originally due in 2003. The remaining proceeds were used to reduce short-term borrowing. The Company issued no long-term debt in 1996. During 1997, the Company repaid approximately \$3.1 million of long-term debt, compared to \$823,000 and \$5.4 million in 1996 and 1995, respectively. The increase in debt payments for 1997 resulted from the payoff of \$2.2 million of debt assumed in the pooling of interests with Tri-County Gas Company, Inc. ("Tri-County").

On March 6, 1997, the Company acquired all of the outstanding common stock of Tri-County and associated properties. Tri-County distributes propane to both retail and wholesale customers on the peninsula. The transaction was effected through the exchange of 639,000 shares of the Company's common stock and was accounted for as a pooling of interests.

Chesapeake issued 32,169, 33,926 and 38,660 shares of common stock in connection with its Automatic Dividend Reinvestment and Stock Purchase Plan during the years of 1997, 1996 and 1995, respectively.

### Results of Operations

Net income for 1997 was \$5,682,946 as compared to \$7,604,915 for 1996. The decrease in net income is primarily related to temperatures in the Company's northern service territory, which were, on average, 6% warmer than in 1996. The warmer weather resulted in a reduction in volumes sold by the natural gas and propane distribution segments. The lower gas volumes contributed to the reduction in Earnings Before Interest and Taxes ("EBIT") for both distribution segments as shown in the table below.

#### EARNINGS BEFORE INTEREST AND TAXES (in thousands):

For the Years Ended December 31,	1997	1996	Increase / (decrease)	1996	1995	Increase / (decrease)
EBIT by Business Segment:						
Natural gas distribution	\$5,498	\$7,167	(\$1,669)	\$7,167	\$4,728	\$2,439
Natural gas transmission	3,721	2,458	1,263	2,458	6,083	(3,625)
Propane distribution	1,064	2,815	(1,751)	2,815	2,252	563
Advanced information services	1,046	1,056	(10)	1,056	1,061	(5)
Other	558	561	(3)	561	(32)	593
Total EBIT	\$11,887	\$14,057	(\$2,170)	\$14,057	\$14,092	(\$35)

Chesapeake's 1996 net income was \$7,604,915, as compared to \$7,593,506 for 1995. Although net income was relatively unchanged, the contribution to net income from each business segment differed during the two-year period. Natural gas distribution EBIT was higher in 1996 due to rate increases placed in effect in two of the three service territories during 1995. EBIT for the propane distribution segment increased due to greater volumes sold due to temperatures being 3% colder than in 1995. Natural gas transmission's contribution decreased due to a reduction in volumes sold to industrial interruptible customers during 1996. In addition, 1995 net income includes a one-time benefit from a settlement with the Federal Energy Regulatory Commission (see Note K to the Consolidated Financial Statements).

### Natural Gas Distribution

The reduction in EBIT of \$1.7 million from 1996 to 1997 is primarily related to a decline in total gross margin, as indicated in the following table, coupled with an overall increase in expenses. The reduction in gross margin earned on volumes sold is primarily the result of a 3% decline in volumes sold to residential and commercial customers and a decrease in volumes sold to industrial interruptible customers in Chesapeake's Florida service territory. The reduction in volumes sold to residential and commercial customers was directly related to warmer temperatures, primarily during the first quarter of 1997. Operations and maintenance expenses increased \$633,000 and \$108,000, respectively.

Compensation, regulatory commission expenses and costs related to data processing and billable service revenue contributed to the increase in operations expenses. A greater level of maintenance to the gas pipeline system resulted in an increase in maintenance expenses.

The \$2.4 million rise in EBIT from 1995 to 1996 resulted from an increase in gross margin earned on sales of natural gas in two of Chesapeake's three service territories, offset by an overall increase in expenses. The \$4.0 million increase in gross margin was partially due to a full year of rate increases, which went into effect in 1995. Maryland operations' rates became effective during December and interim rates were in effect during June of 1995 for Delaware operations. In addition, colder temperatures contributed to the 20% increase in deliveries to residential and commercial customers located in Chesapeake's northern service territory. The \$583,000 increase in operations expenses was primarily the result of higher compensation, benefits, data processing costs, bad debts and regulatory expenses. Plant additions placed in service during 1996 resulted in higher depreciation expense. In addition, other taxes increased by \$460,000 or 23%, partially due to the inclusion of certain state revenue related taxes, which were previously included as reductions to revenue.

#### GROSS MARGIN SUMMARY (in thousands)

For the Years Ended December 31,	1997	1996	Increase / (decrease)	1996	1995	Increase / (decrease)
Revenues:						
Gas sold	\$54,205	\$52,290	\$1,915	\$52,290	\$42,784	\$9,506
Gas transported	3,061	2,991	70	2,991	2,618	373
Gas marketed	18,419	19,382	(963)	19,382	8,555	10,827
Other	275	193	82	193	168	25
Total Revenues	\$75,960	\$74,856	\$1,104	\$74,856	\$54,125	\$20,731
Cost of Sales:						
Gas sold	\$35,507	\$32,846	\$2,661	\$32,846	\$26,789	\$6,057
Gas marketed	18,233	19,117	(884)	19,117	8,410	10,707
Total Cost of Sales	\$53,740	\$51,963	\$1,777	\$51,963	\$35,199	\$16,764
Gross Margin:						
Gas sold	\$18,698	\$19,444	(\$746)	\$19,444	\$15,995	\$3,449
Gas transported	3,061	2,991	70	2,991	2,618	373
Gas marketed	186	265	(79)	265	145	120
Other	275	193	82	193	168	25
Total Gross Margin	\$22,220	\$22,893	(\$673)	\$22,893	\$18,926	\$3,967

\* Transportation service does not have an associated cost of sales.

#### Natural Gas Transmission

The Company's natural gas transmission segment, Eastern Shore, which became an open access pipeline on November 1, 1997, had an increase in EBIT of \$1.3 million for 1997. The rise in EBIT is partially attributable to a rate increase and an increase in firm services implemented in 1997, as well as an overall reduction in expenses. The rate increase is designed to generate additional gross margin of approximately \$1.2 million annually. Also contributing to the increase in EBIT were additional revenues generated by the increase in transportation services that were effective with the implementation of open access. On an annual basis, the additional services will generate revenue of approximately \$1.3 million. Operations expense decreased by \$143,000 or 5%, primarily consisting of compensation, relocation costs and property insurance. Maintenance expenses were also lower due to reduced maintenance required during the year on the gas pipeline system. Capital additions during the year resulted in higher depreciation expense.

The \$3.6 million reduction in 1996 EBIT was primarily due to lower gross margin on sales to industrial customers. The gross margin decreased due to a 67% reduction in volumes delivered, primarily reflecting lower deliveries to two

industrial interruptible customers — a municipal power plant and a methanol plant. The methanol plant shut down operations on April 1, 1996. During 1996 and 1995, deliveries to the methanol and power plants contributed approximately \$284,000 and \$2.4 million, respectively to gross margin. As interruptible customers, they had no ongoing commitment, contractual or otherwise, to purchase natural gas from the Company (see Note A to the Consolidated Financial Statements). The \$109,000 increase in operating expenses reflects increased compensation and benefit related expenses. Depreciation increased due to plant placed in service.

With Eastern Shore's conversion to open access, all of its customers will have the opportunity to transport gas over its system at rates regulated by the FERC. The variability in Eastern Shore's margins, historically driven by the sales to industrial customers, will dramatically decrease, as capacity reservation fees for transportation services will drive prospective margins. It is expected that in the future, Eastern Shore's EBIT will tend to be more stable and resemble a fully regulated return. Taking the 1997 rate increase, revenues associated with additional capacity and lower margins on services provided to industrial customers into account, the Company expects gross margin during 1998 to be between \$7.9 and \$8.2 million (see Cautionary Statement). Comparatively, gross margin for the past three years has been \$7.9 million, \$6.7 million and \$10.2 million for 1997, 1996 and 1995, respectively.

### ***Propane Distribution***

In 1997, Chesapeake integrated the operations of Tri-County and the Company's existing propane distribution operations. Like Chesapeake's existing propane operations, Tri-County's earnings are heavily dependent upon weather conditions.

The reduction in 1997 EBIT of \$1.8 million was primarily due to a reduction in gross margin, partially offset by a reduction in expenses. Gross margin decreased due to an 11% reduction in sales volumes coupled with a 13% lower margin per gallon sold. The decline in sales volumes is directly related to the warmer temperatures, which averaged 6% warmer than the prior year. Furthermore, during the first quarter of 1997 temperatures were 14% warmer than normal. The Company normally sells a high percentage of its annual volume during this period. The reduction in margin per gallon sold was also the result of abnormally warmer temperatures. As temperatures warmed during the first quarter, demand decreased and supply-prices declined rapidly. Due to the low cost of wholesale-supply, retail prices declined, thereby reducing margins. Operations expenses decreased \$554,000 or 7% primarily in the areas of compensation, delivery related costs, advertising and legal fees. Maintenance expenses declined primarily in equipment and structures. Depreciation and amortization expenses declined \$477,000 or 28% primarily the result of a non-compete agreement, which became fully amortized in November of 1996.

The increase in 1996 EBIT of \$563,000 is primarily attributable to a rise in gross margin partially offset by higher expenses. Gross margin was higher due to a 12% increase in volumes sold and a slight increase in margin earned per gallon sold. The increases are directly related to temperatures which were 3% colder than those in 1995. Operating expenses increased \$1.3 million or 19% in 1996 primarily due to compensation, delivery related costs, benefits and outside services. Maintenance expenses increased in the areas of propane storage facilities, equipment and structures.

### ***Advanced Information Services***

The results of the advanced information services segment consisted primarily of those of United Systems, Inc. ("USI"), due to the downsizing of Chesapeake's North Carolina operations in early 1997. Although the EBIT contribution of this segment has remained unchanged from 1996 to 1997, USI's gross margin has increased by \$970,000 or 34%. Operating expenses increased due to the opening of a new office in Detroit, Michigan and the expansion of staff training and marketing efforts to position USI to be able to provide new services and for future growth of current services. Since the rise in operating costs offset most of the growth in gross margin, EBIT remained constant.

Although the EBIT contributed by the advanced information segment was relatively unchanged from 1995 to 1996, EBIT contributed by USI increased \$268,000. This was mostly offset by a reduction in EBIT contributed by the North Carolina operation as they ceased to provide facilities management services beginning in early 1996.

### **Income Taxes**

Operating income taxes in 1997 decreased \$619,000 due to a reduction in EBIT. This was partially offset by the one-time expense of \$318,000 recorded in 1997 to establish the deferred income tax liability for Tri-County. Prior to 1997, Tri-County was a subchapter S Corporation for income tax reporting; therefore, no deferred income taxes were recorded on its balance sheet. In addition, the Company's 1996 and 1995 restated financial statements do not include any income tax expense for Tri-County due to its subchapter S status during those years.

### **Other**

Non-operating income was \$428,000, \$458,000 and \$391,000 for 1997, 1996 and 1995, respectively. The decrease in 1997 is primarily due to a reduction in interest income, partially offset by the gain on the sale of fixed assets. The increase in 1996 is primarily the result of a rise in interest income earned partially offset by a reduction in the gain on sales of fixed assets.

### **Environmental Matters**

The Company continues to work with federal and state environmental agencies to assess the environmental impact and explore corrective action at several former gas manufacturing plant sites (see Note J to the Consolidated Financial Statements). The Company believes that any future costs associated with these sites will be recoverable in rates.

### **The Year 2000**

Chesapeake is dependent upon information systems to operate efficiently and effectively. In order to address the impact of the year 2000 on its many information systems, Chesapeake is in the process of evaluating and remediating any deficiencies. The Company has segregated the evaluation of its readiness and the potential impact of the year 2000 on its systems into two components: primary internal applications and other applications. The Company's primary applications include systems for its financial information; natural gas customer information and billing; and propane customer information, billing and delivery. Other applications include systems for services such as telephone, system control and data acquisition for the pipeline, as well as other vendors' systems. With respect to the three primary applications, Chesapeake has updated its propane customer information, billing and delivery system to a year 2000 compliant version. This system will be tested further to insure compliance during 1998. With respect to the other two primary applications, Chesapeake has conducted initial evaluations and estimates that the cost of any remediation will not be significant. Each application will be tested during 1998. Chesapeake has developed an inventory of other applications and is in the process of developing plans to contact its vendors, test and remediate to the extent necessary.

### **Competition**

Historically, the Company's natural gas operations have successfully competed with other forms of energy such as electricity, oil and propane. The principle considerations have been price, and to a lesser extent, accessibility. As a result of Eastern Shore's recent conversion to open access, the Company expects to be subject to competitive pressures from other sellers of natural gas. With open access transportation services available on Eastern Shore's system, third party suppliers will compete with Chesapeake to sell gas to the local distribution companies and the end users on Eastern Shore's system. Eastern Shore has shifted from providing sales service to providing transportation and contract storage services.

The Company's distribution operations located in Delaware began to offer transportation services to certain industrial customers in December 1997. Chesapeake expects that during 1998, the distribution operations located in Maryland will also begin offering transportation services. The Company expects to expand the availability of transportation services to additional customers in the future. Since the Florida distribution operations have been open to certain industrial



customers since 1994, the Company has gained experience in operating in an open access environment. The Company established a natural gas brokering and supplies operation in Florida to compete for these customers. The Company is evaluating whether to establish similar services in our northern service territory.

Both the propane distribution and the advanced information services businesses face significant competition from a number of larger competitors with substantially greater resources available to them than those of the Company. In addition, in the advanced information services business, changes are occurring rapidly, which could adversely affect the markets for the Company's services.

#### **Inflation**

Inflation affects the cost of labor and other goods and services required for operation, maintenance and capital improvements. The impact of inflation has lessened in recent years, except for the effect on purchased gas costs. These costs are passed on to customers through the purchased gas adjustment clause 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 regulated operations while monitoring the returns of its unregulated business operations.

#### **Cautionary Statement**

Statements made herein and elsewhere in this Form 10-K, which are not historical fact, are forward-looking statements. In connection with the "Safe Harbor" provisions of the Private Securities Litigation Reform Act of 1995, Chesapeake is providing the following cautionary statement to identify important factors that could cause actual results to differ materially from those anticipated in forward-looking statements made herein or otherwise by or on behalf of the Company.

A number of factors and uncertainties make it difficult to predict the effect on future operating results of Eastern Shore operating as an open access pipeline, relative to historical results. While open access eliminates industrial interruptible sales margins, such sales have varied widely from year to year and, in future years, might have made a less significant contribution to earnings even in the absence of open access. Additionally, there are a number of uncertainties, including future open access proceedings and the effects of competition, which will affect whether the Company will be able to provide economical gas marketing, transportation and other services.

In addition, a number of factors and uncertainties affecting other aspects of the Company's business could have a material impact on earnings. These include: the seasonality and temperature sensitivity of Chesapeake's natural gas and propane businesses, the relative price of alternative energy sources and the effects of competition on both unregulated and natural gas sales, now that the Company operates in an open access environment. There are also uncertainties relative to the impact of the year 2000 on the information systems of the Company, its vendors and other third parties.

**Item 8. Financial Statements and Supplemental Data**

**REPORT OF INDEPENDENT ACCOUNTANTS**

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To the Stockholders of  
Chesapeake Utilities Corporation

We have audited the consolidated financial statements and consolidated financial statement schedules of Chesapeake Utilities Corporation and Subsidiaries listed in Item 14(a) of this Form 10-K. These financial statements and financial statement schedules are the responsibility of the Company's Management. Our responsibility is to express an opinion on these financial statements and the financial statement schedules based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. 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. 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Chesapeake Utilities Corporation and Subsidiaries as of December 31, 1997 and 1996, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 1997 in conformity with generally accepted accounting principles. In addition, in our opinion, the consolidated financial statement schedules referred to above, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information required to be included therein.

We have also previously audited, in accordance with generally accepted standards, the consolidated balance sheets and statements of capitalization as of December 31, 1995, 1994 and 1993, and the related consolidated statements of income, cash flows, stockholders' equity, and income taxes for each of the two years in the period ended December 31, 1994 (none of which are presented herein) and we expressed unqualified opinions on those consolidated financial statements. In our opinion, the information set forth in the Financial Highlights included in the Selected Financial Data for each of the five years in the period ended December 31, 1997, appearing on page 15 is fairly stated in all material respects in relation to the financial statements from which it has been derived.

COOPERS & LYBRAND L.L.P.

Baltimore, Maryland  
February 12, 1998

## CONSOLIDATED BALANCE SHEETS

<b>Assets</b>		
<b>At December 31,</b>	<b>1997</b>	<b>1996</b>
<b><i>Property, Plant and Equipment</i></b>		
Natural gas distribution	\$74,769,458	\$69,853,054
Natural gas transmission	33,856,873	30,655,492
Propane distribution	26,920,403	25,279,217
Advanced information services	841,757	1,003,850
Other plant	6,161,631	5,414,249
Gas plant acquisition adjustment	795,004	795,004
Total property, plant and equipment	143,345,126	133,000,866
Less: Accumulated depreciation and amortization	(43,827,961)	(39,430,738)
Net property, plant and equipment	99,517,165	93,570,128
<b><i>Investments</i></b>		
	2,721,443	2,263,068
<b><i>Current Assets</i></b>		
Cash and cash equivalents	555,198	2,213,529
Accounts receivable (less allowance for uncollectibles of \$331,775 and \$392,412 in 1997 and 1996, respectively)	13,087,999	14,488,944
Materials and supplies, at average cost	1,380,120	1,284,876
Propane inventory, at average cost	2,288,516	2,345,531
Storage gas prepayments	2,926,618	3,731,680
Underrecovered purchased gas costs	1,673,389	2,192,170
Income taxes receivable	849,623	112,942
Prepaid expenses	1,060,911	942,359
Deferred income taxes	247,487	158,010
Total current assets	24,069,861	27,470,041
<b><i>Deferred Charges and Other Assets</i></b>		
Environmental regulatory assets	4,865,073	6,650,088
Environmental expenditures, net	2,372,929	1,778,348
Other deferred charges and intangible assets	3,832,389	4,314,235
Total deferred charges and other assets	11,070,391	12,742,671
<b>Total Assets</b>	<b>\$137,378,860</b>	<b>\$136,045,908</b>

*See accompanying notes*

## Capitalization and Liabilities

At December 31,	1997	1996
<b>Capitalization</b>		
Stockholders' equity		
Common stock	\$2,191,792	\$2,160,628
Additional paid-in capital	19,819,604	18,745,718
Retained earnings	28,218,763	26,957,048
Less: Unearned compensation related to restricted stock awarded	(190,886)	(364,529)
Unrealized gain on marketable securities, net	296,872	38,598
Total stockholders' equity	50,336,145	47,537,463
Long-term debt, net of current portion	38,226,000	28,984,368
Total capitalization	88,562,145	76,521,831
<b>Current Liabilities</b>		
Current portion of long-term debt	582,500	3,078,489
Short-term borrowings	7,600,000	12,700,000
Accounts payable	12,451,570	14,426,983
Refunds payable to customers	357,041	353,734
Accrued interest	784,533	741,768
Dividends payable	1,092,168	883,621
Other accrued expenses	3,807,484	3,733,233
Total current liabilities	26,675,296	35,917,828
<b>Deferred Credits and Other Liabilities</b>		
Deferred income taxes	11,490,358	9,798,676
Deferred investment tax credits	821,617	876,432
Environmental liability	4,865,073	6,650,088
Accrued pension costs	1,754,715	1,866,661
Other liabilities	3,209,656	4,414,392
Total deferred credits and other liabilities	22,141,419	23,606,249
<b>Commitments and Contingencies</b>		
<i>(Notes J and K)</i>		
<b>Total Capitalization and Liabilities</b>	<b>\$137,378,860</b>	<b>\$136,045,908</b>

See accompanying notes

## CONSOLIDATED STATEMENTS OF INCOME

For the Years Ended December 31,	1997	1996	1995
<b>Operating Revenues</b>	\$122,774,593	\$130,213,409	\$111,795,778
<b>Cost of Sales</b>	77,764,830	82,226,644	65,616,368
<b>Gross Margin</b>	45,009,763	47,986,765	46,179,410
<b>Operating Expenses</b>			
Operations	21,831,194	22,230,425	20,612,585
Maintenance	2,041,043	2,504,894	2,477,454
Depreciation and amortization	5,396,975	5,504,637	5,802,884
Other taxes	3,853,954	3,689,748	3,194,673
Income taxes	3,327,627	3,947,056	4,025,274
<b>Total operating expenses</b>	36,450,793	37,876,760	36,112,870
<b>Operating Income</b>	8,558,970	10,110,005	10,066,540
<b>Other Income</b>			
Interest income	239,543	249,509	191,845
Other income, net	405,156	177,045	239,687
Income taxes	(216,988)	(83,739)	(105,280)
Allowance for equity funds used during construction		115,434	65,198
<b>Total other income</b>	427,711	458,249	391,450
<b>Income Before Interest Charges</b>	8,986,681	10,568,254	10,457,990
<b>Interest Charges</b>			
Interest on long-term debt	2,347,369	2,392,458	2,282,247
Amortization of debt expense	119,401	120,345	109,399
Other	922,110	514,856	566,320
Allowance for borrowed funds used during construction	(85,145)	(64,320)	(93,482)
<b>Total interest charges</b>	3,303,735	2,963,339	2,864,484
<b>Net Income</b>	\$5,682,946	\$7,604,915	\$7,593,506
<b>Earnings Per Share of Common Stock :</b>			
Basic:	\$1.27	\$1.72	\$1.75
Diluted:	\$1.24	\$1.67	\$1.70

See accompanying notes

## CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31,	1997	1996	1995
<b>Operating Activities</b>			
Net Income	\$5,682,946	\$7,604,915	\$7,593,506
Adjustments to reconcile net income to net operating cash:			
Depreciation and amortization	6,090,665	6,148,232	6,246,222
Allowance for equity funds used during construction		(115,434)	(65,198)
Investment tax credit adjustments	(54,815)	(54,815)	(54,815)
Deferred income taxes, net	1,437,206	1,794,146	252,727
Employee benefits	(238,826)	471,870	178,803
Employee compensation from lapsing of stock restrictions	173,643	334,745	431,694
Allowance for refund			(1,356,705)
Other, net	(286,147)	83,301	(339,081)
Changes in assets and liabilities:			
Accounts receivable, net	1,400,945	(904,516)	(4,727,364)
Other current assets	648,282	(2,141,048)	1,588,675
Other deferred charges	(625,395)	(977,652)	(946,450)
Accounts payable, net	(1,823,912)	1,422,807	3,619,023
Refunds payable to customers	3,307	(613,206)	400,192
Overrecovered (underrecovered) purchased gas costs	518,781	(2,245,544)	162,399
Other current liabilities	(619,668)	396,326	939,750
Net cash provided by operating activities	12,307,012	11,204,127	13,923,378
<b>Investing Activities</b>			
Property, plant and equipment expenditures, net	(12,380,826)	(14,069,116)	(11,666,442)
Allowance for equity funds used during construction		115,434	65,198
Purchases of investments	(36,167)	(129,406)	(38,836)
Net cash used by investing activities	(12,416,993)	(14,083,088)	(11,640,080)
<b>Financing Activities</b>			
Common stock dividends, net of amounts reinvested of \$382,932, \$346,308 and \$304,106 in 1997, 1996 and 1995, respectively	(3,829,752)	(3,337,755)	(3,324,376)
Issuance of stock -- Dividend Reinvestment Plan optional cash	167,337	208,813	202,835
Issuance of stock -- Retirement Savings Plan	404,297	349,031	
Net (repayments) borrowings under line of credit agreements	(5,100,000)	7,300,000	(3,197,039)
Proceeds from issuance of long-term debt	9,908,223		10,428,753
Repayment of long-term debt	(3,098,455)	(823,213)	(5,439,151)
Net cash (used) provided by financing activities	(1,548,350)	3,696,876	(1,328,978)
<b>Net (Decrease) Increase in Cash and Cash Equivalents</b>	(1,658,331)	817,915	954,320
<b>Cash and Cash Equivalents at Beginning of Year</b>	2,213,529	1,395,614	441,294
<b>Cash and Cash Equivalents at End of Year</b>	\$555,198	\$2,213,529	\$1,395,614
<b>Supplemental Disclosure of Cash Flow Information</b>			
Cash paid for interest	\$3,203,709	\$2,831,109	\$2,884,864
Cash paid for income tax	\$3,400,479	\$2,122,120	\$3,288,895

See accompanying notes

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

For the Years Ended December 31,	1997	1996	1995
<b>Common Stock</b>			
Balance -- beginning of year	\$2,160,628	\$2,122,212	\$2,096,515 <sup>(1)</sup>
Dividend Reinvestment Plan	15,398	16,514	18,816
USI restricted stock award agreements		10,639	6,881
Conversion of debentures	4,461	429	
Company's Retirement Savings Plan	11,305	9,928	
Exercised stock options		906	
Balance -- end of year	2,191,792	2,160,628	2,122,212
<b>Additional Paid-in Capital</b>			
Balance -- beginning of year	18,745,718	17,489,108	16,731,689 <sup>(1)</sup>
Dividend Reinvestment Plan	529,453	538,607	488,125
USI restricted stock award agreements		344,570	176,029
Sale of treasury stock to Company's Retirement Savings Plan			93,265
Conversion of debentures	151,441	14,557	
Company's Retirement Savings Plan	392,992	328,465	
Exercised stock options		30,411	
Balance -- end of year	19,819,604	18,745,718	17,489,108
<b>Retained Earnings</b>			
Balance -- beginning of year	26,957,048	23,458,776	19,480,374
Net income	5,682,946	7,604,915	7,593,506 <sup>(1)</sup>
Cash dividends -- Chesapeake <sup>(2)</sup>	(4,341,964)	(3,514,694)	(3,331,972)
Cash dividends -- Pooled companies	(79,267)	(591,949)	(283,132)
Balance -- end of year	28,218,763	26,957,048	23,458,776
<b>Treasury Stock <sup>(3)</sup></b>			
<b>Unearned Compensation</b>			
Balance -- beginning of year	(364,529)	(415,107)	(696,679)
Issuance of award		(284,167)	(121,343)
Amortization of prior years' awards	173,643	334,745	402,915
Balance -- end of year	(190,886)	(364,529)	(415,107)
<b>Unrealized Gain (Loss) on Marketable Securities <sup>(4)</sup></b>	296,872	38,598	(72,839)
<b>Total Stockholders' Equity</b>	<b>\$50,336,145</b>	<b>\$47,537,463</b>	<b>\$42,582,150</b>

<sup>(1)</sup> The following adjustments have been made to 1995 presentation to reflect the Tri-County pooling of interests: Beginning balances of Common Stock and Additional Paid-in Capital have been adjusted by \$311,001 and (\$103,314), respectively. Net income as shown in the Retained Earnings section has been adjusted by \$356,811.

<sup>(2)</sup> Dividends per share of common stock were \$.97, \$.93 and \$.90 for the years 1997, 1996 and 1995, respectively.

<sup>(3)</sup> The entire Treasury Stock balance of (\$99,842) was sold to the Company's Retirement Savings Plan during 1995, leaving a zero balance.

<sup>(4)</sup> Net of income tax expense (benefit) of approximately \$190,000, \$25,000 and (\$48,000) for the years 1997, 1996 and 1995, respectively.

See accompanying notes

## CONSOLIDATED STATEMENTS OF INCOME TAXES

For the Years Ended December 31,	1997	1996	1995
<b>Current Income Tax Expense</b>			
Federal	\$1,916,654	\$1,884,609	\$3,182,346
State	442,563	356,576	621,238
Investment tax credit adjustments, net	(54,815)	(54,815)	(54,815)
Total current income tax expense	2,304,402	2,186,370	3,748,769
<b>Deferred Income Tax Expense</b>			
Property, plant and equipment	1,335,802	581,373	455,151
Deferred gas costs	(204,170)	873,904	(56,915)
Pensions and other employee benefits	(19,508)	107,131	57,508
Unbilled revenue	(104,632)	54,320	(260,922)
Contributions in aid of construction	(33,028)	(6,979)	(283,033)
Environmental expenditures	249,417	108,578	272,068
Allowance for refund		121,671	442,064
Other	16,332	4,427	(244,136)
Total deferred income tax expense <sup>(1)</sup>	1,240,213	1,844,425	381,785
Total Income Tax Expense	\$3,544,615	\$4,030,795	\$4,130,554
<b>Reconciliation of Effective Income Tax Rates</b>			
Federal income tax expense at 34%	3,171,505	3,956,118	3,986,180
State income taxes, net of Federal benefit	399,213	537,566	546,955
Acquisition of subchapter S Corporation <sup>(2)</sup>	317,821	(268,211)	(137,800)
Other	(343,924)	(194,678)	(264,781)
Total income tax expense	\$3,544,615	\$4,030,795	\$4,130,554
Effective income tax rate	38.4%	36.8%	36.3%

For the Years Ended December 31,	1997	1996
<b>Deferred Income Taxes</b>		
Deferred income tax liabilities:		
Property, plant and equipment	\$12,095,782	\$10,716,757
Deferred gas costs	649,681	853,851
Other	1,560,988	1,322,272
Total deferred income tax liabilities	14,306,451	12,892,880
Deferred income tax assets:		
State operating loss carryforwards	57,303	3,320
Deferred investment tax credit	403,789	426,565
Unbilled revenue	968,311	863,679
Pension and other employee benefits	898,060	917,568
Self insurance	585,995	545,836
Other	150,122	495,246
Total deferred income tax assets	3,063,580	3,252,214
Deferred Income Taxes Per Consolidated Balance Sheet	\$11,242,871	\$9,640,666

<sup>(1)</sup> Includes \$208,000, \$392,000 and \$108,000 of deferred state income taxes for the years 1997, 1996 and 1995, respectively.

<sup>(2)</sup> Accounted for as a pooling of interests (see Note B to the Consolidated Financial Statements).

See accompanying notes



## **A. Summary of Accounting Policies**

### **Nature of Business**

Chesapeake Utilities Corporation (the "Company") is engaged in natural gas distribution to approximately 35,800 customers located in southern Delaware, Maryland's Eastern Shore and Central Florida. The Company's natural gas transmission subsidiary operates a pipeline from various points in Pennsylvania to the Company's Delaware and Maryland distribution divisions, as well as other utility and industrial customers in Delaware and the Eastern Shore of Maryland. The Company's propane distribution segment serves approximately 34,000 customers in southern Delaware, the Eastern Shore of Maryland and Virginia. The advanced information services segment provides software services and products to a wide variety of clients.

### **Principles of Consolidation**

The Consolidated Financial Statements include the accounts of the Company and its wholly owned subsidiaries, Eastern Shore Natural Gas Company ("Eastern Shore"), Sharp Energy, Inc. ("Sharp Energy"), Tri-County Gas Company, Inc. ("Tri-County") and Chesapeake Service Company. Sharp Energy's accounts include those of its wholly owned subsidiary, Sharpgas, Inc. Chesapeake Service Company's accounts include United Systems, Inc. ("USI"), Capital Data Systems, Inc. and Skipjack, Inc. Investments in entities in which the Company owns more than 20 percent but 50 percent or less, are accounted for by the equity method. All significant 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 the Delaware, Maryland and Florida Public Service Commissions with respect to their rates for service, maintenance of their accounting records and various other matters. Eastern Shore is subject to regulation by the Federal Energy Regulatory Commission ("FERC"). The Company's financial statements are prepared on the basis of generally accepted accounting principles which give appropriate recognition to the ratemaking and accounting practices and policies of the various commissions. The propane and advanced information services subsidiaries are not subject to regulation with respect to rates or maintenance of accounting records.

### **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. Investments with an original maturity of three months or less are considered cash equivalents.

### **Property, Plant, Equipment and Depreciation**

Utility property is stated at original cost while the assets of the propane subsidiary are valued at cost. The costs of repairs and minor replacements are charged to income as incurred and the costs of major renewals and betterments are capitalized. Upon retirement or disposition of utility property, the recorded cost of removal, net of salvage value, is charged to accumulated depreciation. Upon retirement or disposition of non-utility property, the gain or loss, net of salvage value, is charged to income. The provision for depreciation is computed using the straight-line method at rates, which will amortize the unrecovered cost of depreciable property over the estimated useful life. Depreciation and amortization expense for financial statement purposes is provided at an annual rate for each segment averaging 4.73% for natural gas distribution; 3.04% for natural gas transmission and 5.46% for propane distribution. In addition, the annualized rates average 4.73% for gas plant acquisition adjustments, 17.78% for the advanced information services segment and 2.59% for general plant.

### **Allowance for Funds Used During Construction**

The allowance for funds used during construction ("AFUDC") is an accounting procedure whereby the cost of borrowed funds and other funds used to finance construction projects is capitalized as part of utility plant on the balance sheet, crediting the cost as a non-cash item on the income statement. The costs of borrowed and equity funds are segregated

between interest expense and other income, respectively. AFUDC was capitalized on utility plant construction at the rates of 5.63%, 9.51% and 7.31% for 1997, 1996 and 1995, respectively.

### **Environmental Regulatory Assets**

Environmental regulatory assets represent amounts related to environmental liabilities for which cash expenditures have not been made. As expenditures are incurred, the environmental liability can be reduced along with the environmental regulatory asset. These amounts are recorded to either environmental expenditures or accumulated depreciation as cost of removal. All amounts incurred are amortized in accordance with the ratemaking treatment granted in each jurisdiction.

### **Other Deferred Charges and Intangible Assets**

Other deferred charges include discount, premium and issuance costs associated with long-term debt and rate case expenses. The discount, premium and issuance costs are deferred, then amortized over the original lives of the respective debt issues. Gains and losses on the reacquisition of debt are amortized over the remaining lives of the original issuance(s). Rate case expenses are deferred, then amortized over periods approved by the applicable regulatory authorities. Intangible assets are associated with the acquisition of non-utility companies, and are amortized on a straight-line basis over a period of five to 40 years. The gross intangible assets were \$2,516,120 and \$1,920,851 at December 31, 1997 and 1996, respectively. Accumulated amortization related to intangible assets was \$1,093,905 and \$962,227 at December 31, 1997 and 1996, respectively. In addition, the 1997 acquisition of a propane business resulted in the Company acquiring goodwill, a customer list and a non-compete agreement valued at \$437,000, \$108,000 and \$50,000, respectively.

### **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 and tax bases of assets and liabilities, and are measured using current effective income tax rates. The portion of the Company's deferred tax liabilities applicable to utility operations which has not been reflected in current service rates represents income taxes recoverable through future rates. Investment tax credits on utility property have been deferred and are allocated to income ratably over the lives of the subject property.

The Company had state tax loss carryforwards of \$796,000 and \$46,000 at December 31, 1997 and 1996, respectively. The Company expects to use all of the loss carryforwards; therefore, no valuation allowance was recorded at December 31, 1997 or 1996. The loss carryforwards expire in 2006 through 2012.

### **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 C to the Consolidated Financial Statements for disclosure of fair value of investments). The fair value of the Company's long-term debt is estimated using a discounted cash flow methodology. The estimated fair value of the Company's long-term debt at December 31, 1997, including current maturities, is approximately \$40.7 million as compared to a carrying value of \$38.8 million. At December 31, 1996, the estimated fair value was approximately \$30.3 million as compared to a carrying value of \$29.8 million. These estimates are based on published corporate borrowing rates for debt instruments with similar terms and average maturities.

### **Operating Revenues**

Revenues for the natural gas distribution divisions of the Company are based on rates approved by the various commissions. Customers' base rates may not be changed without formal approval by these commissions. With the exception of the Company's Florida division, the Company recognizes revenues from meters read on a monthly cycle

basis. This practice results in unbilled and unrecorded revenue from the cycle date through month-end. The Florida division recognizes revenues based on services rendered and records an amount for gas delivered but not billed. The propane segment recognizes revenue for certain customers on a metered basis and all other customers on an as-delivered basis.

The natural gas distribution divisions of the Company have purchased gas adjustment ("PGA") clauses that provide for the adjustment of rates charged to customers as gas costs fluctuate. These amounts are collected or refunded through adjustments to rates in subsequent periods.

The natural gas transmission segment became an open access pipeline on November 1, 1997 with revenues based on rates approved by FERC. Before open access, only portions of revenues were based on rates approved by FERC. In addition, the transmission segment had a PGA clause similar to those in the distribution operations. Since the transmission segment records revenue for service only, the PGA clause no longer applies, now that open access is in effect.

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

### Earnings Per Share

The Company has adopted Statement of Financial Accounting Standards ("SFAS") No. 128, issued by the Financial Accounting Standards Board ("FASB") in February 1997, requiring dual presentation of basic and diluted per share earnings on the face of the income statement. Basic earnings per share is based on the weighted average number of shares of common stock outstanding. On a diluted basis, both earnings and shares outstanding are adjusted for stock options for each year presented and the assumed conversion of the convertible debentures. The adoption of SFAS No. 128 did not have a material effect on the Company's financial statements. Prior years' presentations of earnings per share have been restated to conform to the guidelines of SFAS No. 128.

### CALCULATION OF DILUTED EARNINGS PER SHARE:

For the Years Ended December 31,	1997	1996	1995
<u>Reconciliation of Numerator:</u>			
Net Income — basic	\$5,682,946	\$7,604,915	\$7,593,506
Effect of 8.25% Convertible debentures	204,070	207,825	213,043
Adjusted numerator — diluted	\$5,887,016	\$7,812,740	\$7,806,549
<u>Reconciliation of Denominator:</u>			
Weighted Shares Outstanding — basic	4,472,087	4,412,137	4,336,431
Effect of Dilutive Securities			
8.25% Convertible debentures	238,353	242,742	248,833
Stock options and performance shares *	38,462	22,053	4,487
Adjusted denominator — diluted	4,748,902	4,676,932	4,589,751
Diluted Earnings per Share	\$1.24	\$1.67	\$1.70

\* The impact of the 95,492 stock options that were granted in 1997 (see Note H to the Consolidated Financial Statements) could potentially dilute earnings per share in the future.

### Certain Risks and Uncertainties

The financial statements are prepared in conformity with generally accepted accounting principles that require management to make estimates (see Note J to the Consolidated Financial Statements for significant estimates) in measuring assets and liabilities and related revenue and expenses. These estimates involve judgements 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 regulated operations, all such deferred amounts would be recognized in the income statement at that time, resulting in a charge to earnings, net of applicable income taxes.

#### FASB Statements Issued

**Comprehensive Income.** In June 1997, the FASB issued SFAS No. 130 regarding the reporting of comprehensive income in the full set of financial statements. The Company must adopt the requirements of the standard in its financial statements for the year beginning January 1, 1998. The effect of the adoption of the standard pertains primarily to SFAS No. 115 regarding held for sale investments, and is not expected to have a material impact on the Company's financial statements.

**Segment Information.** In June 1997, FASB issued SFAS No. 131, establishing standards for public business enterprises to report information about operating segments in annual financial statements and requiring that those enterprises report selected information about operating segments in interim financial reports to shareholders. The Company will adopt the requirements of this standard in the first quarter of the 1998 fiscal year. The adoption of the standard is not expected to have a material impact on the Company's financial statements.

#### Reclassification of Prior Years' Amounts

Certain prior years' amounts have been reclassified to conform to current year presentation.

#### B. Business Combinations

In March 1997, the Company acquired all of the outstanding common stock of Tri-County Gas Company, Inc. and associated properties. Tri-County's principal business is the distribution of propane to both retail and wholesale customers in southern Delaware, the Eastern Shore of Maryland and Virginia. Six hundred thirty-nine thousand shares of the Company's common stock were exchanged in the transaction, which was accounted for as a pooling of interests. All prior period consolidated financial statements presented have been restated to include the combined results of operations, financial position and cash flows of Tri-County. All material transactions between the Company and Tri-County have been eliminated in consolidation. The results of operations for the separate companies and the combined amounts are presented in the consolidated financial statements to follow.

	Two months ended February 28, 1997	Year Ended December 31, 1996	Year Ended December 31, 1995
Operating Revenues			
Chesapeake	\$29,690,819	\$119,330,068	\$104,020,416
Tri-County	2,652,910	10,883,341	7,775,362
Combined	\$32,343,729	\$130,213,409	\$111,795,778
Net Income			
Chesapeake	\$2,434,351	\$6,910,428	\$7,236,695
Tri-County	265,059	694,487	356,811
Combined	\$2,699,410	\$7,604,915	\$7,593,506
Unaudited Pro Forma Net Income *			
Chesapeake	N/A	\$6,910,428	\$7,236,695
Tri-County	N/A	426,276	219,011
Combined	N/A	\$7,336,704	\$7,455,706

\* Unaudited pro forma net income reflects adjustments to net income to record an estimated provision for income taxes, assuming Tri-County was a tax paying entity in 1996 and 1995. During 1997, Tri-County was a C Corporation for federal income tax purposes. Tri-County will be included in the Company's U.S. federal income tax return, effective March 1997.

#### C. Investments

The investment balance at December 31, 1997 and 1996 consists primarily of the common stock of Florida Public Utilities Company ("FPU"). The Company's ownership at December 31, 1997 and 1996 represents a 7.34% and 7.41%

interest, respectively. The Company has classified its investment in FPU as an "Available for Sale" security, which requires that all unrealized gains and losses be excluded from earnings and be reported net of income tax as a separate component of stockholders' equity. At December 31, 1997 and 1996, the market value exceeded the aggregate cost basis of the Company's portfolio by \$486,872 and \$63,598, respectively.

#### **D. Lease Obligations**

The Company has entered several operating lease arrangements for office space at various locations. Rent expense related to these leases was \$277,000, \$293,000 and \$409,000 for 1997, 1996 and 1995, respectively. Future minimum payments under the Company's current lease agreements are \$236,000; \$228,000; \$232,000; \$145,000 and \$91,000 for the years of 1998 through 2002, respectively; and \$198,000 thereafter.

## E. Segment Information

For the Years Ended December 31,	1997	1996	1995
<b>Operating Revenues, Unaffiliated Customers</b>			
Natural gas distribution	\$75,940,968	\$74,904,100	\$54,120,280
Natural gas transmission	12,164,369	15,188,752	24,984,767
Propane distribution	26,994,404	33,179,114	25,345,696
Advanced information services	7,636,407	6,903,246	7,307,413
Other	38,445	38,197	37,622
<b>Total operating revenues, unaffiliated customers</b>	<b>\$122,774,593</b>	<b>\$130,213,409</b>	<b>\$111,795,778</b>
<b>Intersegment Revenues *</b>			
Natural gas distribution	\$18,970	\$12,232	\$5,095
Natural gas transmission	19,282,359	21,543,352	16,663,043
Propane distribution	52,230	2,059	139,052
Advanced information services	149,602	326,913	1,554,498
Other	523,007	332,512	349,508
<b>Total intersegment revenues</b>	<b>\$20,026,168</b>	<b>\$22,217,068</b>	<b>\$18,711,196</b>
<b>Operating Income Before Income Taxes</b>			
Natural gas distribution	\$5,498,471	\$7,167,237	\$4,728,348
Natural gas transmission	3,721,148	2,458,442	6,083,440
Propane distribution	1,063,554	2,814,958	2,252,165
Advanced information services	1,045,912	1,056,201	1,061,309
Other	524,785	406,632	215,146
<b>Total</b>	<b>11,853,870</b>	<b>13,903,470</b>	<b>14,340,408</b>
Add (Less): Eliminations	32,727	153,591	(248,594)
<b>Total operating income before income taxes</b>	<b>\$11,886,597</b>	<b>\$14,057,061</b>	<b>\$14,091,814</b>
<b>Depreciation and Amortization</b>			
Natural gas distribution	\$3,076,654	\$2,907,831	\$2,468,141
Natural gas transmission	892,258	697,834	638,099
Propane distribution	1,204,968	1,681,588	1,629,971
Advanced information services	122,081	131,877	969,587
Other	101,014	85,507	97,086
<b>Total depreciation and amortization</b>	<b>\$5,396,975</b>	<b>\$5,504,637</b>	<b>\$5,802,884</b>
<b>Capital Expenditures</b>			
Natural gas distribution	\$5,826,065	\$6,472,459	\$7,424,489
Natural gas transmission	3,286,860	5,567,509	1,335,793
Propane distribution	2,820,166	2,189,368	2,427,773
Advanced information services	277,015	162,189	114,461
Other	559,043	445,916	1,584,813
<b>Total capital expenditures</b>	<b>\$12,769,149</b>	<b>\$14,837,441</b>	<b>\$12,887,329</b>
<b>Identifiable Assets, at December 31,</b>			
Natural gas distribution	\$78,732,860	\$77,426,232	\$72,256,841
Natural gas transmission	24,781,292	23,981,989	19,292,524
Propane distribution	24,209,693	25,009,751	22,723,647
Advanced information services	1,751,192	1,496,419	1,635,100
Other	7,903,823	8,131,517	7,430,616
<b>Total identifiable assets</b>	<b>\$137,378,860</b>	<b>\$136,045,908</b>	<b>\$123,338,728</b>

\* All significant intersegment revenues have been eliminated from consolidated revenues.

## F. Long-term Debt

The outstanding long-term debt, net of current maturities, is as follows:

At December 31,	1997	1996
First mortgage sinking fund bonds:		
Adjustable rate Series G*, due January 1, 1998	\$ 0	\$ 62,500
9.37% Series I, due December 15, 2004	4,300,000	4,820,000
12.00% Mortgage, due February 1, 1998		14,868
8.25% Convertible debentures, due March 1, 2014	3,926,000	4,087,000
Uncollateralized Senior notes:		
7.97% note, due February 1, 2008	10,000,000	10,000,000
6.91% note, due October 1, 2010	10,000,000	10,000,000
6.85% note, due January 1, 2012	10,000,000	
Total long-term debt	\$38,226,000	\$28,984,368

\* The Series G bonds are subject to an interest rate equal to seventy-three percent (73%) of the prime rate (8.50% and 8.25% at December 31, 1997 and 1996, respectively).

Annual maturities of consolidated long-term debt for the next five years are as follows: \$582,500 for 1998, \$1,520,000 for 1999 and \$2,665,091 for the years 2000 through 2002.

On December 15, 1997, the Company issued \$10 million of 6.85% senior notes due January 1, 2012. The Company used the proceeds to repay a portion of the Company's short-term borrowing.

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 1997, \$156,000 in debentures were converted. The debentures are redeemable at the option of the holder, subject to an annual non-cumulative maximum limitation of \$200,000 in the aggregate. As of December 31, 1997, no debentures have been accepted for redemption in 1998. At the Company's option, the debentures may be redeemed at the stated amounts.

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% of total capitalization, the times interest earned ratio must be at least 2.5 and the Company cannot, until the retirement of its Series I bonds, pay any dividends after December 31, 1988 which exceed the sum of \$2,135,188 plus consolidated net income recognized on or after January 1, 1989. As of December 31, 1997, the amounts available for future dividends permitted by the Series I covenant approximated \$14.6 million.

A portion of the natural gas distribution plant assets owned by the Company are subject to a lien under the mortgage pursuant to which the Company's first mortgage sinking fund bonds are issued.

## G. Short-term Borrowing

The Board of Directors has authorized the Company to borrow up to \$20.0 million from various bank and trust companies. As of December 31, 1997, the Company had four unsecured bank lines of credit totaling \$34.0 million, none of which required compensating balances. Under these lines of credit at December 31, 1997 and 1996, the Company had short-term debt outstanding of \$7.6 million and \$12.7 million, respectively, with a weighted average interest rate of 5.63% and 6.12%, respectively.

## H. Common Stock, Additional Paid-in Capital and Treasury Stock

The following is a schedule of changes in the Company's shares of common stock.

For the Years Ended December 31,	1997	1996	1995 <sup>(1)</sup>
<b>Common Stock: Shares issued and outstanding<sup>(2)</sup></b>			
Balance – beginning of year	4,439,516	4,360,589	4,307,791
Dividend Reinvestment Plan <sup>(3)</sup>	32,169	33,926	38,660
Sale of stock to Company's Retirement Savings Plan	23,228	20,398	
USI restricted stock award agreements		21,859	14,138
Conversion of debentures	9,166	881	
Exercised stock options		1,863	
Balance – end of year	4,504,079	4,439,516	4,360,589

(1) The 1995 beginning balance of 4,307,791 has been restated to include 639,000 shares of Common Stock that were issued to effect the business combination with Tri-County.

(2) 12,000,000 shares are authorized at a par value of \$.4867 per share.

(3) Includes dividends and reinvested optional cash payments.

At the beginning of 1995, the Company had 15,609 shares of common stock held in treasury. During 1995, all of these were sold to the Company's retirement savings plan.

Certain key USI employees entered into restricted stock award agreements under which shares of Chesapeake common stock can be issued. Shares were awarded as a non-cash transaction over a five-year period beginning in 1992, and restrictions lapse over a five to ten-year period from the award date, if certain financial targets are met. At December 31, 1997 and 1996, respectively, 12,515 and 24,350 shares valued at \$190,886 and \$364,529 remain restricted.

The Performance Incentive Plan, which was adopted in 1992, provides for the granting of stock options to certain officers of the Company over a 10-year period. In November 1994, the Company executed Tandem Stock Option and Performance Share Agreements ("Agreements") with certain executive officers. These Agreements provide the participants an option to purchase shares of the Company's common stock, exercisable in cumulative installments of one-third on each anniversary of the commencement of the award period. The Agreements also enable the participants the right to earn performance shares upon the Company's achievement of the performance goals set forth in the Agreements. During the three-year period ended December 31, 1997, the aforementioned performance goals were achieved. Following the approval of the Board of Directors on February 27, 1998, the Company issued 44,081 performance shares. Forty-four thousand ninety-six stock options expired upon the issuance of the performance shares on February 27. In 1997, the Company recorded \$415,681 to recognize the compensation expense associated with the performance shares. Changes in outstanding options were as follows:

	1997		1996		1995	
	Number of shares	Option Price	Number of shares	Option price	Number of shares	Option Price
Balance – beginning of year	113,051	\$12.625 - \$12.75	125,186	\$12.625 - \$12.75	136,186	\$12.625 - \$12.75
Options granted	95,492	\$20.50				
Options exercised			(12,135)	\$12.75		
Options forfeited					(11,000)	\$12.625
Balance – end of year	208,543	\$12.625 - \$20.50	113,051	\$12.625 - \$12.75	125,186	\$12.625 - \$12.75
Exercisable	98,083	\$12.625 - \$12.75	83,114	\$12.625 - \$12.75	80,280	\$12.75

In December 1997, the Company granted stock options to certain executive officers of the Company. As required by SFAS No. 123, 1997 pro forma net income as if fair value based accounting had been used to account for the stock-based compensation costs is \$5,679,603. Pro forma basic and diluted earnings per share are \$1.27 and \$1.24,



respectively. Pro forma disclosures for 1997 are not likely to be representative of future effects of reported net income. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 1997: dividend yield of 4.73%; expected volatility of 15.53%; risk-free interest rate of 5.89%; and expected lives of four years.

## I. Employee Benefit Plans

### Pension Plan

The Company sponsors a defined benefit pension plan covering substantially all of its employees. Benefits under the plan are based on each participant's years of service and highest average compensation. 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.

### Pension Cost

For the Years Ended December 31,	1997	1996	1995
Service cost	\$680,192	\$656,985	\$474,000
Interest cost	732,188	658,238	562,003
Actual return on assets	(2,427,768)	(1,142,287)	(1,546,325)
Net amortization and deferral	1,421,028	269,135	689,947
Total net pension cost	405,640	442,071	179,625
Amounts capitalized as construction cost	(33,942)	(38,860)	(30,740)
Amount charged to expense	\$371,698	\$403,211	\$148,885

The following schedule sets forth the funding status of the pension plan at December 31, 1997 and 1996.

### Accrued Pension Cost

At December 31,	1997	1996
Vested	\$7,615,194	\$6,834,661
Non-vested	123,255	139,483
Total accumulated benefit obligation	\$7,738,449	\$6,974,144
Plan assets at fair value	\$13,592,699	\$10,720,514
Projected benefit obligation	(11,534,355)	(10,265,987)
Plan assets less projected benefit obligation	2,058,344	454,527
Unrecognized net gain	(4,038,679)	(2,820,957)
Unamortized net assets from adoption of SFAS No. 87	(198,326)	(141,579)
Accrued pension cost	(\$2,178,661)	(\$2,508,009)
<b>Assumptions:</b>		
Discount rate	7.25%	7.25%
Average increase in future compensation levels	4.75%	4.75%
Expected long-term rate of return on assets	8.50%	8.50%

### Other Post-retirement Benefits

The Company sponsors a defined benefit post-retirement health care and life insurance plan that covers substantially all natural gas and corporate employees. The Company had deferred approximately \$126,000, which represented the difference between the Maryland division's SFAS No. 106 expense and its actual pay-as-you-go cost. The amount is being amortized over five years starting in 1995. The unamortized balance is \$78,000 at December 31, 1997.

### Post-retirement Cost

For the Years Ended December 31,	1997	1996	1995
Service cost	\$3,287	\$2,820	\$1,827
Interest cost on APBO	60,221	54,651	59,706

Amortization of transition obligation over 20 years	29,413	27,859	27,859
<b>Net periodic post-retirement benefit cost</b>	92,921	85,330	89,392
Amount capitalized as construction cost	(16,274)	(16,672)	(14,010)
Amount amortized (deferred)	25,254	25,254	(20,561)
Amount charged to expense	\$101,901	\$93,912	\$54,821

#### **Accrued Post-retirement Liability**

At December 31,	1997	1996
<b>Accumulated post-retirement benefit obligation:</b>		
Retirees	\$621,203	\$567,599
Fully eligible active employees	145,356	137,378
Other active	102,340	86,894
Total accumulated post-retirement benefit obligation	868,899	791,871
Unrecognized transition obligation	(245,154)	(273,013)
Unrecognized net (loss) gain	(147,422)	(67,155)
<b>Accrued post-retirement liability</b>	<b>\$476,323</b>	<b>\$451,703</b>
<b>Assumption:</b>		
Discount rate	7.25%	7.25%

The health care inflation rate for 1997 is assumed to be 9.5%. This rate is projected to gradually decrease to an ultimate rate of 5% by the year 2007. A one percentage point increase in the health care inflation rate from the assumed rate would increase the accumulated post-retirement benefit obligation by approximately \$98,650 as of January 1, 1998, and would increase the aggregate of the service cost and interest cost components of net periodic post-retirement benefit cost for 1998 by approximately \$8,293.

#### **Retirement Savings Plan**

The Company sponsors a Retirement Savings Plan, a 401(k) plan ("Plan"), that provides participants a mechanism for making contributions for retirement savings. Each participant may make pre-tax contributions based upon eligible compensation. The Company makes a contribution equal to 60% or 100% of each participant's pre-tax contributions, not to exceed 6%, of the participant's eligible compensation for the plan year. The Company's contributions totaled \$404,406, \$353,350 and \$301,794 for the years ended December 31, 1997, 1996 and 1995, respectively. As of December 31, 1997, there are 56,374 shares reserved to fund future contributions to the Plan.

#### **J. Environmental Commitments and Contingencies**

The Company currently is participating in the investigation, assessment or remediation of three former gas manufacturing plant sites located in different jurisdictions, including the exploration of corrective action options to remove environmental contaminants. The Company has accrued liabilities for two of these sites, the Dover Gas Light and Salisbury Town Gas Light sites.

The Dover site's remediation costs are estimated at \$4.2 million in the Record of Decision ("ROD") issued by the Environmental Protection Agency ("EPA") in January 1998. The Company and General Public Utilities Corporation, Inc. ("GPU") were ordered by the EPA to fund or implement the ROD. During 1998, the Company will commence with the design phase. The Company has adjusted the liability associated with the Dover site from \$6.0 million to \$4.2 million. The Company has also recorded a regulatory asset in the same amount. The previous accrual of \$6.0 million was based on the original Record of Decision issued by the EPA in 1994.

The Company initiated litigation against one of the other potentially responsible parties for contribution to the remedial costs incurred by Chesapeake in connection with complying with the ROD. At this time, management cannot predict

the outcome of the litigation or the amount of proceeds to be received, if any. Management believes that the Company will be equitably entitled to contribution from other responsible parties for a portion of the expenses to be incurred in connection with the remedies selected in the ROD. Management also believes that the amounts not so contributed will be recoverable in the Company's rates.

In cooperation with the Maryland Department of the Environment ("MDE"), in 1996 the Company completed construction and began remediation procedures at the Salisbury site. In addition, the Company began quarterly reporting of the remediation and monitoring results to the MDE. The Company has established a liability with respect to the Salisbury site of \$665,000 as of December 31, 1997. This amount is based on the estimated operating costs of the remediation facilities. A corresponding regulatory asset has been recorded, reflecting the Company's belief that costs incurred will be recoverable in rates.

Portions of the liability payouts for the Dover and Salisbury sites are expected to be over 30 and five-year periods, respectively. In addition, the Company has a site located in the state of Florida, which is currently being evaluated. At this time, no estimate of liability can be made. It is management's opinion that any unrecovered current costs and any other future costs incurred will be recoverable through future rates or sharing arrangements with other responsible parties.

At December 31,	1997	1996
Environmental Costs Incurred		
Delaware	\$5,317,380	\$4,423,843
Maryland	2,368,168	2,187,810
Florida	692,391	660,828
Total costs incurred	8,377,939	7,272,481
Less: Amounts, net of insurance proceeds, which have been approved for ratemaking treatment	(\$7,319,496)	(6,396,108)
Amounts pending ratemaking recovery	\$1,058,443	\$876,373

## K. Commitments and Contingencies

### FERC PGA

In the third quarter of 1995, Eastern Shore reached a settlement with the FERC pertaining to Eastern Shore's PGA methodology. Accordingly, Eastern Shore reversed a large portion of the estimated liability that had been accrued. This reversal contributed \$1,385,000 to pre-tax earnings, or \$833,000 to after-tax earnings, for the period.

### Other Commitments and Contingencies

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 of the Company.

## L. 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. 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
<b>1997</b>				
Operating Revenue	\$43,645,111	\$24,805,428	\$19,910,307	\$34,413,746
Operating Income	\$4,104,438	\$1,409,752	\$25,177	\$3,019,603
Net Income	\$3,366,113	\$692,841	(\$739,193)	\$2,363,185

Earnings per share:				
Basic	\$0.76	\$0.16	(\$0.17)	\$0.53
Diluted	\$0.72	\$0.15	(\$0.17)	\$0.51
<b>1996</b>				
Operating Revenue	\$49,026,542	\$25,213,979	\$19,637,074	\$36,335,814
Operating Income	\$6,667,499	\$1,084,392	(\$160,422)	\$2,518,536
Net Income	\$6,000,157	\$486,311	(\$747,779)	\$1,866,226
Earnings per share:				
Basic	\$1.37	\$0.11	(\$0.17)	\$0.42
Diluted	\$1.30	\$0.11	(\$0.17)	\$0.41

**Item 9. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure**  
None

### PART III

**Item 10. Directors and Executive Officers of the Registrant**

Information pertaining to the Directors of the Company is incorporated herein by reference to the Proxy Statement, under "Information Regarding the Board of Directors and Nominees", dated and to be filed on or before March 30, 1998 in connection with the Company's Annual Meeting to be held on May 19, 1998.

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 Item 10 of Part I of this Form 10-K under "Executive Officers of the Registrant."

**Item 11. Executive Compensation**

This information is incorporated herein by reference to the Proxy Statement, under "Report on Executive Compensation", dated and to be filed on or before March 30, 1998 in connection with the Company's Annual Meeting to be held on May 19, 1998.

**Item 12. Security Ownership of Certain Beneficial Owners and Management**

This information is incorporated herein by reference to the Proxy Statement, under "Beneficial Ownership of the Company's Securities", dated and to be filed on or before March 30, 1998 in connection with the Company's Annual Meeting to be held on May 19, 1998.

**Item 13. Certain Relationships and Related Transactions**

This information is incorporated herein by reference to the Proxy Statement, under "Beneficial Ownership of the Company's Securities", dated and to be filed on or before March 30, 1998 in connection with the Company's Annual Meeting to be held on May 19, 1998.

### PART IV

**Item 14. Financial Statements, Financial Statement Schedules, and Exhibits and Reports on Form 8-K**  
**(a) The following documents are filed as a part of this report:**

1. Financial Statements:

- Accountants' Report dated February 12, 1998 of Coopers & Lybrand L.L.P., Independent Accountants
- Consolidated Statements of Income for each of the three years ended December 31, 1997, 1996 and 1995

- Consolidated Balance Sheets at December 31, 1997 and December 31, 1996
  - Consolidated Statements of Cash Flows for each of the three years ended December 31, 1997, 1996 and 1995
  - Consolidated Statements of Common Stockholders' Equity for each of the three years ended December 31, 1997, 1996 and 1995
  - Consolidated Statements of Income Taxes for each of the three years ended December 31, 1997, 1996 and 1995
  - Notes to Consolidated Financial Statements
2. The following additional information for the years 1997, 1996 and 1995 is submitted herewith:
- 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.

**(b) Reports on Form 8-K**

None.

**(c) Exhibits**

- Exhibit 2(a) - Agreement and Plan of Merger by and between Chesapeake Utilities Corporation and Tri-County Gas Company, Inc., filed on the Company's Form 8-K, File No. 001-11590 on January 13, 1997, is incorporated herein by reference.
- Exhibit 3(a) - Amended Certificate of Incorporation of Chesapeake Utilities Corporation is incorporated herein by reference to Exhibit 3 of the Company's Quarterly Report on Form 10-Q for the period ended June 30, 1995, File No. 001-11590.
- Exhibit 3(b) - Amended Bylaws of Chesapeake Utilities Corporation, effective July 11, 1997, are incorporated herein by reference to Exhibit 3 of the Quarterly Report on Form 10-Q for the period ended June 30, 1997, File No. 001-11590.
- Exhibit 4(a) - 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.
- Exhibit 4(b) - 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.
- Exhibit 4(c) - Directors Stock Compensation Plan adopted by Chesapeake Utilities Corporation in 1995 is incorporated herein by reference to the Company's Proxy Statement dated April 17, 1995 in connection with the Company's Annual Meeting held in May 1995.
- Exhibit 4(d) - 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 Commission upon request.

- Exhibit 4(e)      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 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 Commission upon request.
- Exhibit 10(a) - Service Agreement dated November 1, 1989, by and between Transcontinental Gas Pipe Line Corporation and Eastern Shore Natural Gas Company, is incorporated herein by reference to Exhibit 10 to the Company's Annual Report on Form 10-K for the year ended December 31, 1989, File No. 0-593.
- Exhibit 10(b) - Service Agreement dated November 1, 1989, by and between Columbia Gas Transmission Corporation and Eastern Shore Natural Gas Company, is incorporated herein by reference to Exhibit 10 to the Company's Annual Report on Form 10-K for the year ended December 31, 1989, File No. 0-593.
- Exhibit 10(c) - Service Agreement for General Service dated November 1, 1989, by and between Florida Gas Transmission Company and Chesapeake Utilities Corporation, is incorporated herein by reference to Exhibit 10 to the Company's Annual Report on Form 10-K for the year ended December 31, 1990, File No. 0-593.
- Exhibit 10(d) - Service Agreement for Preferred Service dated November 1, 1989, by and between Florida Gas Transmission Company and Chesapeake Utilities Corporation, is incorporated herein by reference to Exhibit 10 to the Company's Annual Report on Form 10-K for the year ended December 31, 1990, File No. 0-593.
- Exhibit 10(e) - Service Agreement for Firm Transportation Service dated November 1, 1989, by and between Florida Gas Transmission Company and Chesapeake Utilities Corporation, is incorporated herein by reference to Exhibit 10 to the Company's Annual Report on Form 10-K for the year ended December 31, 1990, File No. 0-593.
- Exhibit 10(f) - Form of Service Agreement for Interruptible Sales Services dated May 11, 1990, by and between Florida Gas Transmission Company and Chesapeake Utilities Corporation, is incorporated herein by reference to Exhibit 10 to the Company's Annual Report on Form 10-K for the year ended December 31, 1990, File No. 0-593.
- Exhibit 10(g) - Interruptible Transportation Service Agreement dated February 23, 1990, by and between Florida Gas Transmission Company and Chesapeake Utilities Corporation, is incorporated herein by reference to Exhibit 10 to the Company's Annual Report on Form 10-K for the year ended December 31, 1990, File No. 0-593.
- Exhibit 10(h) - Interruptible Transportation Service Agreement dated November 30, 1990, by and between Florida Gas Transmission Company and Chesapeake Utilities Corporation, is incorporated herein by reference to Exhibit 10 to the Company's Annual Report on Form 10-K for the year ended December 31, 1990, File No. 0-593.
- Exhibit 10(i) - Executive Employment Agreement dated March 26, 1997, by and between Chesapeake Utilities Corporation and each Ralph J. Adkins and John R. Schimkaitis is incorporated herein by reference to Exhibit 10 to the Company's Quarterly Report on Form 10-Q for the period ended June 30, 1997, File No. 001-11590.

- Exhibit 10(j) - Form of Performance Share Agreement dated January 1, 1998, pursuant to Chesapeake Utilities Corporation Performance Incentive Plan by and between Chesapeake Utilities Corporation and each of Ralph J. Adkins and John R. Schimkaitis is filed herewith.
- Exhibit 10(k) - Chesapeake Utilities Corporation Cash Bonus Incentive Plan dated January 1, 1992, is incorporated herein by reference to Exhibit 10 to the Company's Annual Report on Form 10-K for the year ended December 31, 1991, File No. 0-593.
- Exhibit 10(l) - Chesapeake Utilities Corporation Performance Incentive Plan dated January 1, 1992, is incorporated herein by reference to the Company's Proxy Statement dated April 20, 1992, in connection with the Company's Annual Meeting held on May 19, 1992.
- Exhibit 10(m) - Form of Stock Option Agreement dated January 1, 1998, pursuant to Chesapeake Utilities Corporation Performance Incentive Plan by and between Chesapeake Utilities Corporation and each of Michael P. McMasters, Stephen C. Thompson, William C. Boyles, Philip S. Barefoot, Jeremy D. West, William P. Schneider and James R. Schneider, is filed herewith.
- Exhibit 12 - Computation of Ratio of Earning to Fixed Charges, filed herewith.
- Exhibit 21 - Subsidiaries of the Registrant, filed herewith.
- Exhibit 23 - Consent of Independent Accountants, filed herewith.

## 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/ RALPH J. ADKINS  
Ralph J. Adkins  
Chairman of the Board and Chief Executive Officer  
Date: March 20, 1998

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,  
Chief Executive Officer and Director  
Date: March 20, 1998

/s/ JOHN R. SCHIMKAITIS  
John R. Schimkaitis, President,  
Chief Operating Officer and Director  
Date: March 20, 1998

/s/ MICHAEL P. MCMASTERS  
Michael P. McMasters, Vice President,  
Chief Financial Officer and Treasurer  
(Principal Financial Officer)  
Date: March 20, 1998

/s/ RICHARD BERNSTEIN  
Richard Bernstein, Director  
Date: March 20, 1998

/s/ WALTER J. COLEMAN  
Walter J. Coleman, Director  
Date: March 20, 1998

/s/ JOHN W. JARDINE, JR.  
John W. Jardine, Jr., Director  
Date: March 20, 1998

/s/ RUDOLPH M. PEINS, JR.  
Rudolph M. Peins, Jr., Director  
Date: March 20, 1998

/s/ ROBERT F. RIDER  
Robert F. Rider, Director  
Date: March 20, 1998

/s/ JEREMIAH P. SHEA  
Jeremiah P. Shea, Director  
Date: March 20, 1998

/s/ WILLIAM G. WARDEN, III  
William G. Warden, III, Director  
Date: March 20, 1998



**CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES**  
**SCHEDULE II**  
**VALUATION AND QUALIFYING ACCOUNTS**

**FOR THE YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995**

<u>COLUMN A</u>	<u>COLUMN B</u>	<u>COLUMN C</u>		<u>COLUMN D</u>	<u>COLUMN E</u>
		<u>---- Additions ----</u>			
<u>Description</u>	<u>Balance at</u>	<u>Charged to</u>	<u>Charged to</u>		<u>Balance at</u>
	<u>Beginning</u>	<u>Costs and</u>	<u>Other</u>		<u>End</u>
	<u>of Period</u>	<u>Expense</u>	<u>Accounts</u>	<u>Deductions</u>	<u>of Period</u>
Valuation accounts deducted from assets to which they apply for doubtful accounts receivable:					
1997 .....	\$392,412	\$203,624	\$68,038 (B)	(\$332,299) (A)	\$331,775
1996 .....	\$309,955	\$364,622	\$55,631 (B)	(\$337,796) (A)	\$392,412
1995 .....	\$202,152	\$328,012	\$43,151 (B)	(\$263,360) (A)	\$309,955

**Notes:**

(A) Uncollectible accounts charged off.

(B) Recoveries.

**CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES**  
**EXHIBIT 12**  
**COMPUTATION OF RATIO OF EARNINGS TO FIXED CHARGES**

	For the Years Ended December 31,		
	1997	1996	1995
Income from continuing operations	\$5,682,946	\$7,604,915	\$7,593,506
Add:			
Income taxes	3,599,430	4,085,610	3,865,179
Portion of rents representative of interest factor	140,491	129,223	182,211
Interest on indebtedness	3,269,479	2,907,314	2,848,567
Amortization of debt discount and expense	119,401	120,345	109,399
Earnings as adjusted	<u>\$12,811,747</u>	<u>\$14,847,407</u>	<u>\$14,598,862</u>
Fixed Charges			
Portion of rents representative of interest factor	\$140,491	\$129,223	\$182,211
Interest on indebtedness	3,269,479	2,907,314	2,848,567
Amortization of debt discount and expense	119,401	120,345	109,399
Fixed Charges	<u>\$3,529,371</u>	<u>\$3,156,882</u>	<u>\$3,140,177</u>
Ratio of Earnings to Fixed Charges	<u>3.63</u>	<u>4.70</u>	<u>4.65</u>

**CHESAPEAKE UTILITIES CORPORATION**  
**EXHIBIT 21**  
**SUBSIDIARIES OF THE REGISTRANT**

**Subsidiaries**

Eastern Shore Natural Gas Company  
Sharp Energy, Inc.  
Chesapeake Services Company  
United Systems, Inc.  
Tri-County Gas Company, Inc.  
Eastern Shore Real Estate

**State Incorporated**

Delaware  
Delaware  
Delaware  
Georgia  
Maryland  
Maryland

**Subsidiary of Eastern Shore Natural Gas Company**

Dover Exploration Company

**State Incorporated**

Delaware

**Subsidiaries of Sharp Energy, Inc.**

Sharpgas, Inc.  
Sharpoil, Inc.

**State Incorporated**

Delaware  
Delaware

**Subsidiaries of Chesapeake Service Company**

Skipjack, Inc.  
Capital Data Systems, Inc.  
Currin and Associates, Inc.  
Chesapeake Investment Company

**State Incorporated**

Delaware  
North Carolina  
North Carolina  
Delaware

## CONSENT OF INDEPENDENT ACCOUNTANTS

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We consent to the incorporation by reference in the Prospectuses of Chesapeake Utilities Corporation on Form S-2 (File No. 33-26582), Form S-3 (File Nos. 33-28391 and 33-64671) and Form S-8 (File No. 33-301175) of our report dated February 12, 1998 on our audits of the consolidated financial statements and the consolidated financial statement schedules of Chesapeake Utilities Corporation as of December 31, 1997 and 1996 and for each of the three years in the period ended December 31, 1997 included in this Annual Report on Form 10-K.

COOPERS & LYBRAND L.L.P.

Baltimore, Maryland  
March 23, 1998

*Upon written request,  
Chesapeake will provide, without  
charge, a copy of any exhibit to  
Chesapeake's Annual Report on  
Form 10-K not included herewith.*

**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

- ☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 1997

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 001-11590

**CHESAPEAKE UTILITIES CORPORATION**

(Exact name of registrant as specified in its charter)

Delaware  
(State of other jurisdiction of  
incorporation or organization)

51-0064146  
(I.R.S. Employer  
Identification No.)

909 Silver Lake Boulevard, Dover, Delaware 19904  
(Address of principal executive offices) (Zip Code)

(302) 734-6798  
(Registrant's Telephone Number, Including Area Code)

\_\_\_\_\_  
(Former name, former address and former fiscal year, if changed since last report.)

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 ☒ No ☐.

Common Stock, par value \$.4867 - 4,481,394 shares issued as of September 30, 1997.

**PART I**  
**FINANCIAL INFORMATION**

**CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

<b>Assets</b>	<b>September 30, 1997 (Unaudited)</b>	<b>December 31, 1996 (As restated)</b>
<b>Property, Plant And Equipment</b>		
Natural gas distribution	\$74,148,712	\$70,497,872
Natural gas transmission	33,399,202	30,655,492
Propane distribution	26,762,385	25,279,217
Advanced information services	823,375	1,003,850
Other plant	5,025,689	4,769,431
Gas plant acquisition adjustment	795,004	795,004
Total property, plant and equipment	140,954,367	133,000,866
Less: Accumulated depreciation and amortization	(42,800,914)	(39,430,738)
Net property, plant and equipment	98,153,453	93,570,128
<b>Investments</b>	2,340,007	2,263,068
<b>Current Assets</b>		
Cash and cash equivalents	1,467,700	2,213,529
Accounts receivable, less allowance for uncollectibles	7,357,140	14,488,945
Materials and supplies, at average cost	1,684,040	1,284,876
Propane inventory, at average cost	2,426,356	2,345,531
Storage gas prepayments	4,005,715	3,731,680
Underrecovered purchased gas costs	203,556	2,192,170
Income taxes receivable	0	112,942
Prepaid expenses	750,720	942,359
Deferred income taxes	813,681	158,010
Total current assets	18,708,908	27,470,042
<b>Deferred Charges and Other Assets</b>		
Environmental regulatory assets	6,501,505	6,650,088
Environmental expenditures, net	2,262,938	1,778,348
Order 636 transition cost	0	943,209
Other deferred charges and intangible assets	3,853,401	3,371,027
Total deferred charges and other assets	12,617,844	12,742,672
<b>Total Assets</b>	<u>\$131,820,212</u>	<u>\$136,045,910</u>

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

**CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

	September 30, 1997 (Unaudited)	December 31, 1996 (As restated)
<b>- Capitalization and Liabilities</b>		
<b>Capitalization</b>		
Stockholders' equity		
Common Stock, par value \$.4867 per share; (authorized 12,000,000 shares; issued 4,481,394 and 4,439,516 shares, respectively)	\$2,181,014	\$2,160,628
Additional paid-in capital	19,433,280	18,745,718
Retained earnings	26,947,737	26,957,049
Less:		
Unearned compensation - restricted stock awards	(234,348)	(364,529)
Net unrealized gain on marketable securities	64,560	38,598
Total stockholders' equity	48,392,243	47,537,464
Long-term debt, net of current portion	28,642,000	30,776,919
Total capitalization	77,034,243	78,314,383
<b>Current Liabilities</b>		
Current portion of long-term debt	659,868	1,285,938
Short-term borrowings	18,400,000	12,700,000
Accounts payable	6,348,741	14,426,983
Refunds payable to customers	336,575	353,734
Income taxes payable	216,574	
Accrued interest	619,444	741,768
Dividends payable	1,086,650	883,621
Other accrued expenses	3,862,271	3,733,235
Total current liabilities	31,530,123	34,125,279
<b>Deferred Credits and Other Liabilities</b>		
Deferred income taxes	10,230,179	9,798,676
Deferred investment tax credits	840,201	876,432
Environmental liability	6,501,505	6,650,088
Accrued pension costs	2,230,258	1,866,660
Order 636 transition liability	0	943,209
Other liabilities	3,453,703	3,471,183
Total deferred credits and other liabilities	23,255,846	23,606,248
<b>Total Capitalization and Liabilities</b>	<b>\$131,820,212</b>	<b>\$136,045,910</b>

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



**CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED INCOME STATEMENTS**

	For the Quarter Ended September 30,	
	1997 (Unaudited)	1996 (As restated)
Operating Revenues	\$19,915,309	\$19,647,677
Operating Expenses		
Purchased gas costs	11,078,236	11,464,752
Operations	6,668,866	5,873,772
Maintenance	460,577	645,609
Depreciation and amortization	1,374,574	1,403,152
Other taxes	857,846	806,480
Income taxes	(549,967)	(385,666)
Total operating expenses	19,890,132	19,808,099
Operating Income	25,177	(160,422)
Other Income and Deductions	52,029	114,203
Income Before Interest Charges	77,206	(46,219)
Interest Charges	816,399	701,560
Net Income	(\$739,193)	(\$747,779)
Earnings Per Share of Common Stock		
Earnings per share	(\$0.17)	(\$0.17)
Average shares outstanding	4,477,569	4,422,835

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

**CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED INCOME STATEMENTS**

	For the Nine Months Ended September 30,	
	1997 (Unaudited)	1996 (As restated)
Operating Revenues	\$88,286,384	\$93,896,237
Operating Expenses		
Purchased gas costs	52,983,499	56,200,448
Operations	19,138,841	18,409,062
Maintenance	1,551,932	1,840,266
Depreciation and amortization	4,071,882	4,223,444
Other taxes	2,894,350	2,759,268
Income taxes	2,111,636	2,872,281
Total operating expenses	82,752,140	86,304,769
Operating Income	5,534,244	7,591,468
Other Income and Deductions	180,847	261,749
Income Before Interest Charges	5,715,091	7,853,217
Interest Charges	2,395,330	2,114,528
Net Income	\$3,319,761	\$5,738,689
Earnings Per Share of Common Stock (1):		
Primary:		
Earnings per share	\$0.74	\$1.30
Average shares outstanding	4,488,482	4,423,878
Fully Diluted:		
Earnings per share	\$0.73	\$1.26
Average shares outstanding	4,733,912	4,671,289

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

(1) See Exhibit 11 - Computation of Primary and Fully Diluted Earnings Per Share

## CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES

### NOTES TO FINANCIAL STATEMENTS (UNAUDITED)

#### 1. Quarterly Financial Data

The financial information included herein is unaudited; however, the financial information reflects normal recurring adjustments, which are, in the opinion of management, necessary for a fair presentation of the Company's interim results. Due to the seasonal nature of the Company's business, there are substantial variations in the results of operations reported on a quarterly basis. Certain amounts in 1996 have been reclassified to conform with the 1997 presentation.

#### 2. Acquisition

On March 6, 1997, the Company acquired all of the outstanding common stock of Tri-County Gas Company, Inc. ("Tri-County") and associated properties. The principal business of Tri-County is the distribution of propane to both retail and wholesale customers on the Delmarva Peninsula.

The transaction was effected through the exchange of 639,000 shares of the Company's common stock and accounted for as a pooling of interests. Accordingly, the financial statements for 1997 and 1996, as restated, include the financial results of Tri-County along with the shares of stock issued in connection with the acquisition as required by the accounting rules.

The combined operations of the Company and Tri-County serves approximately 34,000 propane customers on the Delmarva Peninsula.

#### 3. Financial Accounting Standards Board ("FASB") Statements Issued

##### SFAS No. 128 — Earnings Per Share

In February 1997, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 128 regarding earnings per share, requiring the dual presentation of basic and diluted earnings per share on the face of the income statement for all entities with a complex capital structure. The Company must adopt the requirements of this standard in its financial statements for the year ended December 31, 1997. Adoption of this standard is not expected to have a material impact on the financial statements of the Company.

##### SFAS No. 130 — Reporting Comprehensive Income

In June 1997, the FASB issued SFAS No. 130 regarding the reporting of comprehensive income in the full set of financial statements. The Company must adopt the requirements of the standard in its financial statements for the year beginning January 1, 1998. The effects of the adoption of the standard are currently under evaluation by the Company.

##### SFAS No. 131 — Disclosure About Segments of an Enterprise and Related Information

In June 1997, the FASB issued SFAS No. 131, establishing standards for the way that public business enterprises report information about operating segments in annual financial statements and requiring that those enterprises report selected information about operating segments in interim financial reports to shareholders. The Company will adopt the requirements of this standard in the first quarter for the fiscal year 1998.

#### 4. Commitments and Contingencies — Environmental Matters

The Company currently is participating in the investigation, assessment and remediation of three former gas manufacturing plant sites located in different jurisdictions, including the exploration of

**CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	For the Nine Months Ended September 30,	
	1997 (Unaudited)	1996 (As restated)
<b>Operating Activities</b>		
Net Income	\$3,319,761	\$5,738,689
Adjustments to reconcile net income to net operating cash		
Depreciation and amortization	4,575,567	4,934,216
Deferred income taxes, net	(275,145)	220,549
Investment tax credit adjustments	(36,231)	(36,231)
Employee benefits	363,597	328,412
Employee compensation from lapsing stock restrictions	130,181	257,204
Other	(1,109,270)	(420,383)
Changes in assets and liabilities:		
Accounts receivable	7,131,804	6,721,321
Inventory, materials, supplies and storage gas	(754,024)	(1,578,465)
Prepaid expenses	191,641	(157,759)
Other deferred charges	531,703	316,389
Accounts payable	(8,078,242)	(5,173,828)
Refunds payable to customers	(17,159)	(302,299)
Over/(Under) recovered purchased gas costs	1,988,614	(631,181)
Other current liabilities	336,226	474,175
Net cash provided by operating activities	<u>8,299,023</u>	<u>10,690,809</u>
<b>Investing Activities</b>		
Property, plant and equipment expenditures, net	<u>(9,565,768)</u>	<u>(9,372,957)</u>
Net cash used by investing activities	<u>(9,565,768)</u>	<u>(9,372,957)</u>
<b>Financing Activities</b>		
Common stock dividends net of amounts reinvested of \$409,920 and \$426,341, respectively	(2,716,123)	(2,168,446)
Net repayments under line of credit agreements	5,700,000	825,000
Proceeds from issuance of stock to Company 401(k) plan	298,028	260,126
Repayments of long-term debt	<u>(2,760,989)</u>	<u>(586,646)</u>
Net cash used by financing activities	<u>520,916</u>	<u>(1,669,966)</u>
<b>Net Decrease in Cash</b>	<u>(745,829)</u>	<u>(352,114)</u>
<b>Cash and Cash Equivalents at Beginning of Period</b>	<u>2,213,529</u>	<u>1,395,614</u>
<b>Cash and Cash Equivalents at End of Period</b>	<u>\$1,467,700</u>	<u>\$1,043,500</u>

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

corrective action options to remove environmental contaminants. The Company has accrued liabilities for two of these sites, the Dover Gas Light and Salisbury Town Gas Light sites.

#### **Dover Gas Light Site**

The Dover site has been listed by the Environmental Protection Agency Region III ("EPA") on the Superfund National Priorities List under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"). On August 19, 1994, the EPA issued the Record of Decision ("ROD") for the site, which selected a remedial plan and estimated the costs of the selected remedy at \$2.7 million for ground-water remediation and \$3.3 million for soil remediation. On May 17, 1995, EPA issued an order to the Company under Section 106 of CERCLA (the "Order"), which requires the Company to fund or implement the ROD. The Order was also issued to General Public Utilities Corporation, Inc. ("GPU"). Other potentially responsible parties ("PRPs") such as the State of Delaware were not ordered to perform the ROD. Please refer to "Environmental -- Dover Gas Light Site" in the Company's report on Form 10-K for additional information pertaining to the cost to remediate the site, investigations related to additional parties who may be PRPs and/or litigation initiated by the Company pertaining to the site.

In conjunction with the commencement of the design phase of the ROD, a pre-design investigation report ("the report") was filed in October 1996 with the EPA. The report, which requires EPA approval, provided an up to date status on the site, which the EPA will use to determine if the remedial design selected in the ROD is still the appropriate remedy.

In the report, the Company proposed a modification to the soil cleanup remedy selected in the ROD to take into account an existing land use restriction that bans future development at the site. In April of 1997, the EPA issued a fact sheet stating that the EPA was considering the proposed modification. The fact sheet included an overall cost estimate of \$5.7 million for the proposed modified remedy and a new overall cost estimate of \$13.2 million for the remedy selected in the ROD. On August 28, 1997, the EPA issued a Proposed Plan to modify the current clean-up plan that would involve: (1) excavation and off-site thermal treatment of the contents of the former subsurface gas holders; (2) implementation of soil vaporization extraction; (3) pavement of the parking lot; and (4) use of institutional controls that would restrict future development of the Site. The overall clean-up cost of the Site under the proposed plan was estimated at \$4.2 million, as compared to EPA's estimate of the current clean-up plan at \$13.2 million.

EPA's public comment period began August 29, 1997 and closed on September 29, 1997. The EPA will consider all comments received during this public comment period before any final decision is made. If the decision is made to modify the current clean-up plan, it will be formally noted by an amendment to the ROD.

In 1994, the Company increased its accrued liability recorded with respect to the Dover Site to \$6.0 million. This amount reflected the EPA's estimate, as stated in the ROD, for remediation of the site. Current estimates for remediation of the site range from \$4.2 million to \$13.2 million, depending on the remedy selected by the EPA. The Company has not adjusted its \$6.0 million accrual, since at this time, it is management's opinion that no one amount within the range can be determined to be a better estimate of the cost to remediate the site. The recorded liability may be adjusted upward or downward, depending on the outcome of the EPA's reconsideration of the remedy and the Company's estimate of the cost of the remedy selected. The Company has also recorded a regulatory asset of \$6.0 million, corresponding to the recorded liability. Management believes that in addition to the \$600,000 expected to be contributed by the State of Delaware under the Settlement, the Company will

be equitably entitled to contribution from other responsible parties for a portion of the expenses to be incurred in connection with the remedies selected in the ROD.

As of September 30, 1997, the Company has incurred approximately \$4.9 million in costs relating to environmental testing and remedial action studies. In 1990, the Company entered into settlement agreements with a number of insurance companies resulting in proceeds to fund actual environmental costs incurred over a five to seven-year period beginning in 1990. In December 1995, the Delaware Public Service Commission authorized a process to review and provide recovery of all current and future unrecovered environmental costs incurred by a means of a rider (supplement) to base rates, applicable to all firm service customers. As of September 30, 1997, \$966,000 of environmental costs are not included in the rider, effective December 1, 1996. With the rider mechanism established, it is management's opinion that these costs and any future costs, net of the deferred income tax benefit, will be recoverable in rates. For additional information pertaining to the rider, please refer to "Environmental -- Dover Gas Light Site" on page 15 of the Company's report on Form 10-K.

#### **Salisbury Town Gas Light Site**

In cooperation with the Maryland Department of the Environment ("MDE"), in 1996 the Company completed construction and began remediation procedures at the Salisbury site. In addition, the Company began quarterly reporting of the remediation and monitoring results to the MDE.

The cost of remediation is estimated to range from \$140,000 to \$190,000 per year for operating expenses. Based on these estimated costs, the Company recorded both a liability and a deferred regulatory asset of \$650,088 on December 31, 1996, to cover the Company's projected remediation costs for this site. The liability payout for this site is expected to be over a five-year period. As of September 30, 1997, the Company has incurred approximately \$2.3 million for remedial actions and environmental studies. In January 1990, the Company entered into settlement agreements with a number of insurance companies resulting in proceeds to fund actual environmental costs incurred over a three to five-year period beginning in 1990. The final insurance proceeds were requested and received in 1992. In December 1995, the Maryland Public Service Commission approved recovery of all environmental costs incurred through September 30, 1995 less amounts previously amortized and insurance proceeds. The amount approved for a 10-year amortization period was \$964,251. Of the \$2.3 million in costs reported above, approximately \$566,000 has not been recovered through insurance proceeds or received ratemaking treatment. It is management's opinion that these and any future costs incurred, will be recoverable in rates.

#### **Winter Haven Coal Gas Site**

In May 1996, the company filed an Air Sparging and Soil Vapor Extraction Pilot Study Work Plan for the Winter Haven site with the Florida Department of Environmental Protection ("FDEP"). The Work Plan described the Company's proposal to undertake an Air Sparging and Soil Vapor Extraction ("AS/SVE") pilot study to evaluate at the site. After discussions with the FDEP, the Company filed a modified AS/SVE Pilot Study Work Plan, scope of work to complete the site assessment activities and a report describing a limited sediment investigation performed recently. The Company will be awaiting FDEP's comments to the modified Work Plan. It is not possible to determine whether remedial action will be required by FDEP and, if so, the cost of such remediation.

The company has spent and received ratemaking treatment of approximately \$678,000 on these investigations as of September 30, 1997. The Company has been allowed by the Florida Public Service Commission to continue to accrue for future environmental costs. At September 30, 1997, the Company had \$432,000 accrued. It is management's opinion that future costs, if any, will be recoverable in rates.

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

## RESULTS OF OPERATIONS FOR THE QUARTER ENDED SEPTEMBER 30, 1997

The Company recognized a net loss of \$739,193 for the three months ended September 30, 1997, representing a decrease in net loss of \$8,586 as compared to the corresponding period in 1996. The financial results for 1997 and 1996 include the operating results of Tri-County Gas Company, Inc. ("Tri-County"), which was acquired on March 6, 1997 and was accounted for as a pooling of interests. As indicated in the table below, the decrease in loss before interest and taxes ("LBIT") is due to greater earnings before interest and taxes ("EBIT") for the natural gas transmission, information services and other segments, a decrease in LBIT in propane distribution, offset by an increased LBIT in the natural gas distribution segment.

	FOR THE QUARTER ENDED SEPTEMBER 30,		
	<u>1997</u>	<u>1996</u>	<u>Change</u>
<u>Loss Before Interest and Taxes</u>			
Natural Gas Distribution	\$ (497,846)	\$ (251,778)	\$ (246,068)
Natural Gas Transmission	777,484	600,455	177,029
Propane Distribution	(1,165,868)	(1,191,129)	25,261
Advanced Information Services	254,381	204,145	50,236
Eliminations & Other	107,059	92,219	14,840
Total LBIT	(524,790)	(546,088)	21,298
Operating Income Taxes	(549,967)	(385,666)	(164,301)
Interest	816,399	701,560	114,839
Non-Operating (Loss) Income, Net	52,029	114,203	(62,174)
Net Loss	<u>\$ (739,193)</u>	<u>\$ (747,779)</u>	<u>\$ 8,586</u>

### Natural Gas Distribution

The natural gas distribution segment reported LBIT of \$497,846 for the third quarter of 1997 as compared to \$251,778 for the corresponding period last year — an increase of \$246,068. The increase in LBIT is due to higher operating expenses mostly offset by an increase in gross margin.

	FOR THE QUARTER ENDED SEPTEMBER 30,		
	<u>1997</u>	<u>1996</u>	<u>Change</u>
Revenue	\$11,488,507	\$11,372,713	\$ 115,794
Cost of Gas	7,793,376	7,938,243	(144,867)
Gross Margin	3,695,131	3,434,470	260,661
Operations & Maintenance	2,824,374	2,417,837	406,537
Depreciation & Amortization	795,382	748,030	47,352
Other Taxes	573,221	520,381	52,840
EBIT	<u>\$ (497,846)</u>	<u>\$ (251,778)</u>	<u>\$ (246,068)</u>

The increase in gross margin is primarily due to an \$86,000 increase in revenue from service work, customer growth and rate restructurings which went into effect during the first half of 1997. Operations expenses increased in the areas of billable service work, payroll, legal fees, outside services and regulatory related expenses. The increase in maintenance expenses is primarily due to maintenance of

mains. Depreciation and amortization expense increased due to plant placed in service during the past twelve months. Other taxes were higher due to revenue related taxes and property taxes.

### Natural Gas Transmission

The natural gas transmission segment reported EBIT of \$777,484 for the third quarter of 1997 as compared to EBIT of \$600,455 for the corresponding period last year — an increase of \$177,029. The increase in EBIT is primarily due to an increase in gross margin somewhat offset by higher expenses.

	FOR THE QUARTER ENDED SEPTEMBER 30,		
	1997	1996	Change
Revenue	\$ 6,857,335	\$ 6,701,703	\$ 155,632
Cost of Gas	5,078,678	5,109,832	(31,154)
Gross Margin	1,778,657	1,591,871	186,786
Operations & Maintenance	680,275	709,022	(28,747)
Depreciation & Amortization	223,928	185,249	38,679
Other Taxes	96,970	97,145	(175)
EBIT	<u>\$ 777,484</u>	<u>\$ 600,455</u>	<u>\$ 177,029</u>

The gross margin increase was primarily the result of a rate increase that went into effect mid-April. The higher rates resulted from of Eastern Shore Natural Gas Company's ("Eastern Shore") rate increase filing with the Federal Energy Regulatory Commission ("FERC"). Eastern Shore reached a settlement with FERC during the quarter, and any refund resulting from the settlement has been accrued, pending final approval. Operations expenses increased \$42,000, primarily in the areas of legal fees, outside services and corporate related costs offset by a decrease in payroll. Depreciation and amortization increased due to the capital additions placed in service during the past twelve months.

As previously reported, Eastern Shore filed with FERC an abbreviated application for a blanket certificate of public convenience to provide open access transportation service. Effective November 1, 1997, Eastern Shore initiated the provision of open access transportation services on its system. Eastern Shore will no longer sell gas, but has converted to a provider of contract storage and transportation services. Going forward, third party suppliers will compete with the Company to sell gas to the local distribution companies and the end users on Eastern Shore's system.

### Propane Distribution

For the third quarter of 1997, the propane distribution segment experienced LBIT of \$1,165,868. These results were more favorable than those achieved for the corresponding quarter of 1996, with the segment recognizing a decrease in LBIT of \$25,261 over the third quarter 1996 LBIT of \$1,191,129. The decrease in LBIT was attributable to lower operating expenses partially offset by a decrease in gross margin. The 1997 and 1996 financial results of the propane distribution segment include the operating results of Tri-County.



	FOR THE QUARTER ENDED SEPTEMBER 30,		
	<u>1997</u>	<u>1996</u>	<u>Change</u>
Revenue	\$ 2,979,855	\$ 3,335,058	\$ (355,203)
Cost of Gas	1,640,731	1,787,561	(146,830)
Gross Margin	1,339,124	1,547,497	(208,373)
Operations & Maintenance	2,097,645	2,206,200	(108,555)
Depreciation & Amortization	308,341	427,116	(118,775)
Other Taxes	99,006	105,310	(6,304)
EBIT	<u>\$ (1,165,868)</u>	<u>\$ (1,191,129)</u>	<u>\$ 25,261</u>

The decrease in gross margin is due primarily to a 9% reduction in deliveries and a 15% reduction in margin earned per gallon sold. Decreased expenses for vehicles, buildings and equipment resulted in lower maintenance costs. Depreciation and amortization expense decreased \$118,775 which is primarily the result of a non-compete agreement which became fully amortized in November of 1996. Other taxes increased due to property taxes on capital additions in 1996.

#### Advanced Information Services

The advanced information services segment recognized an EBIT of \$254,381 and \$204,145 for the quarters ended September 30, 1997 and 1996, respectively. This increase in EBIT of \$50,236 is attributable to higher revenue slightly offset by increased operating expenses.

	FOR THE QUARTER ENDED SEPTEMBER 30,		
	<u>1997</u>	<u>1996</u>	<u>Change</u>
Revenue	\$ 2,051,180	\$ 1,663,855	\$ 387,325
Operations & Maintenance	1,685,265	1,372,266	312,999
Depreciation & Amortization	33,412	30,630	2,782
Other Taxes	78,122	56,814	21,308
EBIT	<u>\$ 254,381</u>	<u>\$ 204,145</u>	<u>\$ 50,236</u>

The increase in revenue is due primarily to increases in consulting and resource services. Operations expenses were higher due to billable compensation directly related to increases in revenue, non-billable compensation and other costs related to overall growth.

#### Interest

The increase in interest expense is associated with higher short-term borrowing balances, as compared to the same period last year.

#### Operating Income Taxes

Operating income taxes decreased by \$164,301 primarily due to the propane distribution segment not including income tax benefits, since Tri-County was a subchapter S corporation prior to the acquisition in the first quarter of 1997.

#### Non-Operating Income (Loss)

The increase in the loss for the quarter is primarily due to a reduction in interest income and the allowance for equity funds used during construction ("AFUDC").

# **RESULTS OF OPERATIONS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 1997**

The Company recognized net income of \$3,319,761 for the nine months ended September 30, 1997, representing a decrease in net income of \$2,418,928 as compared to the corresponding period in 1996. The financial results for 1997 and 1996 include the operating results of Tri-County. As indicated in the table below, the decrease in EBIT is due to lower earnings in the natural gas and propane distribution segments, partially offset by increased earnings in transmission, advanced information services and other.

	FOR THE NINE MONTHS ENDED SEPTEMBER 30,		
	<u>1997</u>	<u>1996</u>	<u>Change</u>
<u>Earnings Before Interest and Taxes</u>			
Natural Gas Distribution	\$ 3,921,919	\$ 5,631,176	\$(1,709,257)
Natural Gas Transmission	2,091,774	1,797,540	294,234
Propane Distribution	224,979	1,886,140	(1,661,161)
Advanced Information Services	975,681	770,100	205,581
Eliminations & Other	431,527	378,793	52,734
Total EBIT	7,645,880	10,463,749	(2,817,869)
Operating Income Taxes	2,111,636	2,872,281	(760,645)
Interest	2,395,330	2,114,528	280,802
Non-Operating Income, Net	180,847	261,749	(80,902)
Net Income	<u>\$ 3,319,761</u>	<u>\$ 5,738,689</u>	<u>\$(2,418,928)</u>

## **Natural Gas Distribution**

The natural gas distribution segment reported EBIT of \$3,921,919 for the first nine months of 1997 as compared to EBIT of \$5,631,176 for the corresponding period last year. The decrease in EBIT is due to a reduction in gross margin, coupled with increased expenses.

	FOR THE NINE MONTHS ENDED SEPTEMBER 30,		
	<u>1997</u>	<u>1996</u>	<u>Change</u>
Revenue	\$53,778,615	\$54,691,434	\$ (912,819)
Cost of Gas	37,432,642	37,729,820	(297,178)
Gross Margin	16,345,973	16,961,614	(615,641)
Operations & Maintenance	8,232,520	7,269,995	962,525
Depreciation & Amortization	2,371,871	2,324,536	47,335
Other Taxes	1,919,663	1,825,907	93,756
EBIT	<u>\$ 3,821,919</u>	<u>\$ 5,541,176</u>	<u>\$(1,719,257)</u>

The decrease in gross margin is primarily due to first quarter temperatures which were 14% warmer than the first quarter in 1996, resulting in an 11% reduction in deliveries during that period. Partially offsetting the decrease in margin was an \$89,000 increase in service work revenue. Operations expenses increased in the areas of billable service work, legal fees, outside services, data processing and regulatory related expenses. Maintenance expenses primarily increased in mains, meters and regulators. Depreciation and amortization expense increased due to plant placed in service during the last twelve months.

### Natural Gas Transmission

The natural gas transmission segment reported EBIT of \$2,091,774 for the first nine months of 1997 as compared to EBIT of \$1,797,540 for the corresponding period last year — an increase of \$294,234. The increase in EBIT is due to an increase in gross margin.

	FOR THE NINE MONTHS ENDED SEPTEMBER 30,		
	<u>1997</u>	<u>1996</u>	<u>Change</u>
Revenue	\$25,590,929	\$26,071,935	\$ (481,006)
Cost of Gas	20,332,861	21,130,517	(797,656)
Gross Margin	5,258,068	4,941,418	316,650
Operations & Maintenance	2,190,647	2,267,391	(76,744)
Depreciation & Amortization	669,304	567,913	101,391
Other Taxes	306,343	308,574	(2,231)
EBIT	<u>\$ 2,091,774</u>	<u>\$ 1,797,540</u>	<u>\$ 294,234</u>

The gross margin increase was primarily the result of a rate increase that went into effect in mid-April. The higher rates were subject to refund pending the final outcome of the Eastern Shore rate increase filing with the FERC. A settlement was reached with FERC during the quarter and any refunds have been accrued. Operations and maintenance expenses decreased in the areas of compensation and data processing. These reductions were somewhat offset by an increase in legal fees. Depreciation and amortization increased due to the capital additions placed in service during the past twelve months.

### Propane Distribution

The propane distribution segment recognized EBIT of \$224,979 for the first nine months of 1997, as compared to EBIT of \$1,886,140 for the nine months ended September 30, 1996. The financial results for 1997 and 1996 include the operating results of Tri-County. The decrease in EBIT of \$1,661,161 was primarily due to a reduction in gross margin, somewhat offset by lower expenses.

	FOR THE NINE MONTHS ENDED SEPTEMBER 30,		
	<u>1997</u>	<u>1996</u>	<u>Change</u>
Revenue	\$18,528,761	\$22,439,111	\$ (3,910,350)
Cost of Gas	10,674,599	11,992,755	(1,318,156)
Gross Margin	7,854,162	10,446,356	(2,592,194)
Operations & Maintenance	6,357,357	6,909,408	(552,051)
Depreciation & Amortization	896,218	1,281,157	(384,939)
Other Taxes	375,608	369,651	5,957
EBIT	<u>\$ 224,979</u>	<u>\$ 1,886,140</u>	<u>\$ (1,661,161)</u>

The decrease in gross margin occurred primarily during the first quarter when sales volumes and margin earned per gallon sold declined 21% and 20%, respectively. The declines resulted from warm temperatures experienced during the first quarter of 1997. Year to date volumes are still down 13% and margin earned per gallon sold declined 17%. Operations expenses declined in the areas of legal fees, outside services and compensation. Depreciation and amortization expense decreased \$384,939 which is primarily the result of a non-compete agreement which became fully amortized in November 1996.

### Advanced Information Services

For the nine months ended September 30, the advanced information services segment recognized an EBIT of \$975,681 and \$770,100 for 1997 and 1996, respectively. This increase in EBIT of \$205,581 is the outcome of higher revenue and lower operating expenses.

	FOR THE NINE MONTHS ENDED SEPTEMBER 30,		
	1997	1996	Change
Revenue	\$ 5,954,733	\$ 5,482,677	\$ 472,056
Operations & Maintenance	4,641,232	4,395,184	246,048
Depreciation & Amortization	84,175	102,978	(18,803)
Other Taxes	253,645	214,415	39,230
EBIT	<u>\$ 975,681</u>	<u>\$ 770,100</u>	<u>\$ 205,581</u>

The increase in revenue occurred primarily in consulting and resource services due to a rise in demand for PROGRESS training and programmers. Operations expenses were higher due to billable compensation directly related to increases in revenue, non-billable compensation and other costs related to overall growth.

### Interest

The increase in interest expense is associated with higher short-term borrowing balances, as compared to the same period last year.

### Operating Income Taxes

Operating income taxes decreased \$760,645 due to a reduction in EBIT and the lack of income tax expense recorded by Tri-County in 1996, offset by a one-time expense of \$318,000 recorded during the first quarter. The one-time expense was required to establish deferred income taxes for Tri-County Gas Company, Inc., acquired during the first quarter of 1997. Prior to the acquisition, Tri-County Gas Company, Inc. was a Subchapter S Corporation for income tax reporting; therefore, no deferred income taxes were recorded on its balance sheet. In addition, the Company's 1996 restated financial statements do not include any income tax expense on EBIT reported for Tri-County due to its 1996 Subchapter S status.

### Non-Operating Income

The decrease in 1997 is related primarily to a reduction in interest income and AFUDC. In addition, 1996 includes a one-time gain on the sale of real property.

### Environmental Matters

The Company continues to work with federal and state environmental agencies to assess the environmental impacts and explore corrective action at several former gas manufacturing plant sites (see Note 4 to the Consolidated Financial Statements). The Company believes that any future costs associated with these sites will be recoverable in future rates.

## FINANCIAL POSITION, LIQUIDITY AND CAPITAL RESOURCES

The Company's capital requirements reflect the capital intensive nature of its business and are attributable principally to its construction program and the retirement of its outstanding debt. The Company relies on funds provided by operations and short-term borrowings to meet normal working capital requirements and temporarily finance capital expenditures. During the first nine months of 1997, the Company's net cash flow provided by operating activities, net cash used by investing activities and net cash used by financing activities were approximately \$8.3 million, \$9.6 million and \$520,000, respectively. Due to the seasonal nature of the Company's business, there are substantial variations in the results of operations reported on a quarterly basis.

The Board of Directors has authorized the Company to borrow up to \$24 million from banks and trust companies. As of September 30, 1997, the Company had one \$10 million and three \$8 million unsecured bank lines of credit. Funds provided from these lines of credit are used for short-term cash needs to meet seasonal working capital requirements and to fund portions of its capital expenditures. The outstanding balances of short-term borrowings at September 30, 1997 and 1996 were \$18.4 and \$6.2 million, respectively.

During the nine months ended September 30, 1997 and 1996, net property, plant and equipment expenditures were approximately \$9.6 and \$9.4 million, respectively. For 1997, the Company has budgeted \$15.6 million for capital expenditures. The components of this amount include \$7.5 million for natural gas distribution, \$4.3 million for natural gas transmission, \$1.2 million for environmental related expenditures, \$1.9 million for propane distribution, \$350,000 for advanced information services, with the remaining \$350,000 for computers, office equipment and general plant. The natural gas and propane distribution expenditures are for expansion and improvement. Natural gas transmission expenditures are to improve the pipeline system and completion of the Delaware City compressor station. Financing of the 1997 construction will be provided primarily by short-term borrowings and cash from operations and the issuance of the long-term debt. The Company is in the process of finalizing a refinancing of \$10 million of short-term debt with a 6.85% senior note. The refinancing is expected to be consummated in December 1997. The construction program is subject to continuous review and modification by management. Actual construction expenditures may vary from the above estimates due to a number of factors including inflation, changing economic conditions, regulation, load growth and the cost and availability of capital.

The Company expects to incur environmental related expenditures in the future (see Note 4 to the Consolidated Financial Statements), a portion of which may need to be financed through external sources. Management does not expect such financing to have a material adverse effect on the financial position or capital resources of the Company.

The Company is continually evaluating new business opportunities and acquisitions, some of which may require the Company to obtain financing. Management will consider the impact of any such financing on the Company's financial position in its evaluation of the business opportunity or acquisition. Such financings are not expected to have a material adverse effect on the financial position or capital resources of the Company.

As of September 30, 1997, common equity represented 62.8% of permanent capitalization, compared to 60.7% as of December 31, 1996. The Company remains committed to maintaining a sound capital structure and strong credit ratings in order 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, helps to ensure that the Company will be able to attract capital from outside sources at a reasonable cost.

**PART II  
OTHER INFORMATION**

**CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES**

- Item 1: Legal Proceedings  
See Note 2 to the Consolidated Financial Statements
- Item 2: Changes in Securities  
None
- Item 3: Defaults Upon Senior Securities  
None
- Item 4: Submission of Matters to a Vote of Security Holders  
None
- Item 5: Other Information  
None
- Item 6(a): Exhibits  
Exhibit 11 - Computation of Primary and Fully Diluted Earnings Per Share is submitted herewith.
- Item 6 (b): Reports on Form 8-K  
None

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CHESAPEAKE UTILITIES CORPORATION

/s/ Michael P. McMasters

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Michael P. McMasters  
Vice President, Treasurer and Chief Financial Officer

Date: November 12, 1997

# CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES

## EXHIBIT 11 COMPUTATION OF PRIMARY AND FULLY DILUTED EARNINGS PER SHARE

	For the Quarter Ended September 30, (1)		For the Nine Months Ended September 30,	
	1997	1996	1997	1996
Primary earnings per share calculation:				
Weighted average number of shares	4,502,279	4,442,713	4,488,482	4,423,878
Consolidated net income	(\$739,193)	(\$747,779)	\$3,319,761	\$5,738,689
Primary earnings per share	(\$0.16)	(\$0.17)	\$0.74	\$1.30
Fully diluted earnings per share calculation:				
Weighted average number of shares	4,507,798	4,445,501	4,493,708	4,427,862
Contingent shares related to assumed conversion of convertible debt	239,939	242,171	240,204	243,427
Weighted average number of shares assuming full dilution	4,747,737	4,687,672	4,733,912	4,671,289
Adjusted income				
Consolidated net income	(\$739,193)	(\$747,779)	\$3,319,761	\$5,738,689
Interest on convertible debt	84,882	85,438	252,157	255,775
Less: Applicable income taxes	(33,104)	(33,321)	(98,341)	(99,752)
Adjusted net income	(\$687,415)	(\$695,662)	\$3,473,577	\$5,894,712
Fully diluted earnings per share	(\$0.14)	(\$0.15)	\$0.73	\$1.26

- (1) This calculation is submitted in accordance with Regulation S-K item 601(b)(11), although it is contrary to paragraph 40 of APB Opinion No. 15, because it produces an anti-dilutive result for the quarters ended September 30, 1997 and 1996.



## UNAUDITED

	ACTUAL BEFORE ISSUANCE			PRO FORMA BEFORE ISSUANCE			PRO FORMA AFTER ISSUANCE OF EQUITY	
TYPE OF CAPITAL	AMOUNT OUTSTANDING	% OF TOTAL	ADJUSTMENT	AMOUNT OUTSTANDING	% OF TOTAL	ISSUANCE OF COMMON STOCK	AMOUNT OUTSTANDING	% OF TOTAL
COMMON EQUITY								
COMMON STOCK	\$2,191,792	2.27%	\$12,168	\$2,203,960	2.26%	\$231,183	\$2,435,142	2.50%
PAID IN CAPITAL	19,819,604	20.49%	38,833	19,858,437	20.38%	(156,183)	19,702,254	20.21%
RETAINED EARNINGS	28,324,749	29.28%	144,536	28,469,285	29.22%	3,233,252	31,702,537	32.52%
TOTAL COMMON EQUITY	50,336,145	52.04%	195,536	50,531,681	51.86%	3,308,252	53,839,933	55.23%
PREFERRED STOCK	0	0.00%	0	0	0.00%	0	0	0.00%
LONG-TERM DEBT								
FIRST MORTGAGE BONDS	4,300,000	4.44%	0	4,300,000	4.41%	0	4,300,000	4.41%
CONVERTIBLE DEBENTURES	3,926,000	4.06%	0	3,926,000	4.03%	0	3,926,000	4.03%
OTHER LONG-TERM DEBT	30,000,000	31.01%	0	30,000,000	30.79%	0	30,000,000	30.78%
TOTAL LONG-TERM DEBT	38,226,000	39.51%	0	38,226,000	39.23%	0	38,226,000	39.22%
TOTAL PERMANENT CAPITAL	88,562,145	91.55%	195,536	88,757,681	91.09%	3,308,252	92,065,933	94.45%
CURRENT PORTION OF LTD	582,500	0.60%	0	582,500	0.60%	0	582,500	0.60%
SHORT-TERM DEBT	7,600,000	7.85%	489,076	8,089,076	8.31%	(3,256,925)	4,832,151	4.95%
TOTAL CAPITALIZATION	\$96,744,645	100.00%	\$684,612	\$97,429,257	100.00%	\$51,327	\$97,480,584	100.00%

CHESAPEAKE UTILITIES CORP. 1997  
Schedule No. 2  
Rate of Return, Actual Annualized and Pro Forma  
For the Twelve Months Ended December 31, 1997

UNAUDITED

	ACTUAL BEFORE ISSUANCE	ADJUSTMENT	PRO FORMA BEFORE ISSUANCE	ISSUANCE OF COMMON STOCK	PRO FORMA AFTER ISSUANCE OF EQUITY
<i>Statement of Income</i>					
1 Operating revenues	\$122,774,593	\$1,539,638	\$124,314,231	\$127,451,157	\$251,765,388
2 Operating expenses before income taxes	\$110,887,996	\$1,416,291	\$112,304,287	\$126,663,957	\$238,968,244
3 Income taxes (Including Deferrals)	\$3,327,627	\$38,331	\$3,365,958	\$267,648	\$3,633,606
4 Operating Income (1-(2+3))	\$8,558,970	\$85,016	\$8,643,986	\$519,552	\$9,163,538
5 AFUDC (Equity Only)	\$0	\$0	\$0	\$0	\$0
6 Other Income, Net	\$427,711	\$1,290	\$429,001	\$378,129	\$807,130
7 Income Before Interest Charges (4+5+6)	\$8,986,681	\$86,306	\$9,072,987	\$897,681	\$9,970,668
8 Interest Charges (Including debt portion of AFUDC)	\$3,303,735	\$27,519	\$3,331,254	\$0	\$3,331,254
9 Net Income From Continuing Operations (7-8)	\$5,682,946	\$58,787	\$5,741,733	\$897,681	\$6,639,414
10 Preferred stock dividends	\$0	\$0	\$0	\$0	\$0
11 Earnings available to common equity (9-10)	\$5,682,946	\$58,787	\$5,741,733	\$897,681	\$6,639,414
12 Average capitalization	\$79,914,832	\$195,536	\$80,110,368	\$3,308,252	\$83,418,620
13 Average common equity	\$49,233,558	\$195,536	\$49,429,094	\$3,308,252	\$52,737,346
14 Return on average capitalization (7/12)	11.25%		11.33%		11.95%
15 Return on average common equity (11/13)	11.54%		11.62%		12.59%

UNAUDITED

Type of Method	HISTORICAL		ANNUALIZED	
	ACTUAL BEFORE ISSUANCE	PRO FORMA AFTER ISSUANCE OF EQUITY	PRO FORMA BEFORE ISSUANCE	PRO FORMA AFTER ISSUANCE OF EQUITY
<u>Per Financial Statements</u>				
Before Income Taxes, all interest	3.6383	3.7055	3.6174	3.9811
Before Income Taxes, all interest, before AFUDC	3.6383	3.7055	3.6174	3.9811
After Income Taxes, all interest	1.6500	1.7156	1.6369	1.9124
After Income Taxes, all interest, before AFUDC	1.6500	1.7156	1.6369	1.9124
Overall Coverage, (after income taxes)	1.6500	1.7156	1.6369	1.9124
Overall Coverage, (after income taxes) before AFUDC	1.6500	1.7156	1.6369	1.9124
<u>Modified Indenture Method</u>				
Before Income Taxes, all interest	3.4146	3.4801	3.3892	3.7381
Before Income Taxes, all interest, before AFUDC	3.4146	3.4801	3.3892	3.7381
After Income Taxes, all interest	1.5147	1.5778	1.4960	1.7621
After Income Taxes, all interest, before AFUDC	1.5147	1.5778	1.4960	1.7621
Overall Coverage, (after income taxes)	1.5147	1.5778	1.4960	1.7621
Overall Coverage, (after income taxes) before AFUDC	1.5147	1.5778	1.4960	1.7621



AND, the Commission having examined the Company's application and made such investigation in connection with said matters as the Commission deemed necessary, and having heard the presentation of the Company and the Commission Staff at the Commission meeting of May 26, 1998;

AND, the Commission having been advised by Staff of certain concerns that Staff has regarding said merger and its potential effect on ratepayers of the Delaware Division of Chesapeake and the Company having agreed to certain conditions;

AND, the Commission having been advised, and having determined, that the proposed issuance of 475,000 shares of Chesapeake common stock in accordance with the Merger Agreement is in accordance with law, for a proper purpose, and consistent with the public interest; now, therefore,

**IT IS ORDERED THAT:**

1. The application filed by Chesapeake Utilities Corporation in this matter on or about April 29, 1998, is hereby approved and Chesapeake Utilities Corporation is hereby authorized to issue up to 475,000 shares of its common stock to consummate the Merger Agreement.

2. Said application and approval is based and conditioned upon: (1) Chesapeake Utilities Corporation's representation and guarantee that no expenses associated with this acquisition and merger shall be recovered in the future, in rates, from Delaware Division ratepayers; (2) Chesapeake Utilities Corporation hereby agrees not to seek recovery from Delaware Division ratepayers any costs associated with any environmental liability arising from or in connection with any business activity conducted by or to be conducted by Xeron, Inc., including ownership of any real estate assets; and (3) that Chesapeake Utilities Corporation will quantify and allocate to Delaware Division ratepayers those savings in corporate overhead expenses that may be achieved through and as a result of this merger.

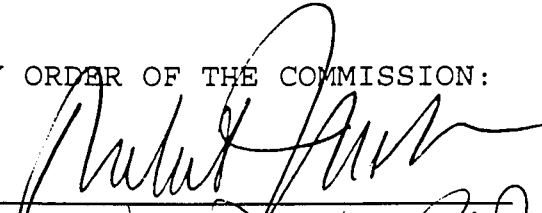
3. Approval of Chesapeake Utilities Corporation's application by the Commission shall not be construed as approving any capitalization ratios that result for any purposes or procedures involving ratemaking; nor are the Commission's rules regarding the burden of proving the merits of any related issue waived hereby. The Commission's approval of Chesapeake Utilities Corporation's application is limited to that which is necessary under 26 Del. C. § 215.

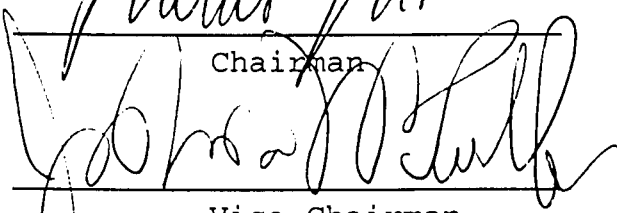
4. Nothing in this Order shall be construed as a guarantee, warranty, or representation by the State of Delaware or by any agency, commission, or department hereof, with respect to the Shares to be issued pursuant to the Merger Agreement and this Order.

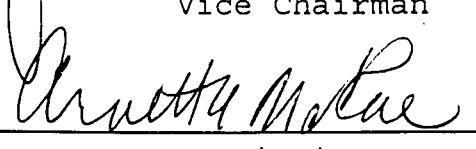
5. That Chesapeake Utilities Corporation shall file with this Commission a written report within sixty (60) days of the closing of the merger transaction setting forth the steps which have been taken in connection with such transaction including, but not limited to, the resulting capitalization ratios arising from the issuance of Chesapeake's common stock.

6. That the Commission reserves the jurisdiction and authority to enter such further Orders in this matter as may be deemed necessary or proper.

BY ORDER OF THE COMMISSION:

  
Chairman

  
Vice Chairman

  
Commissioner

PSC Docket No. 98-197, Order No. 4798 Cont'd.

  
\_\_\_\_\_  
Commissioner

  
\_\_\_\_\_  
Commissioner

ATTEST:

  
\_\_\_\_\_  
Acting Secretary



## LAW OFFICES

Exhibit 8

## LAWS &amp; LAWS, P.A.

209 EAST MAIN STREET

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VICTOR H. LAWS  
COUNSELVICTOR H. LAWS, III  
JEAN S. LAWS

KATHRYN KNEE †

†ALSO ADM. IN PA., FLA.

208 CEDAR STREET  
CAMBRIDGE, MARYLAND 21613  
TELEPHONE: (410) 376-0287March 31, 1998

Dashiell J. Shannahan  
Joyce C. Shannahan  
Sam Shannahan Well Co., Inc.  
d/b/a Tolan Water Service  
716 Naylor Mill Road  
Salisbury, MD 21801

Dear Mr. and Mrs. Shannahan:

We have acted as counsel to Chesapeake Utilities Corporation (the "Purchaser") in connection with the execution and delivery of that certain Agreement and Plan of Merger dated March 20, 1998 (the "Merger Agreement"), by and among Purchaser, CPK Sub-B, Inc. ("CPK Sub-B"), Sam Shannahan Well Co., Inc., d/b/a Tolan Water Service, Dashiell J. Shannahan and Joyce C. Shannahan. Capitalized terms used, but not defined, herein shall have the same meanings assigned to such terms in the Merger Agreement. This opinion is being furnished to you pursuant to Section 8.2(e) of the Merger Agreement.

In connection with the opinion set forth below, we have examined originals, or copies, certified or otherwise identified to our satisfaction, of the following documents: (a) the Certificate of Incorporation and Bylaws of the Purchaser; (b) the Merger Agreement; (c) such instruments, certificates, records, and other documents as we have deemed necessary or appropriate as a basis for the opinions expressed below.

We have assumed, without independent verification, the genuineness of all signatures; the legal capacity of natural persons; the valid existence of each party to the Merger Agreement, other than the Purchaser and CPK Sub-B; that each party to the Merger Agreement, other than the Purchaser and CPK Sub-B, has the power and authority to execute and deliver, and to perform its obligations under, the Merger Agreement; the due authorization, execution and delivery of the Merger Agreement by each party thereto other than the Purchaser and CPK Sub-B; the enforceability of the Merger Agreement against each party thereto other than the Purchaser and CPK Sub-B; and the authenticity of all documents submitted to us as originals, the conformity to original documents of all documents submitted to us as certified, photostatic, reproduced or conformed, copies, and the authenticity of the originals of such copies. As to matters of fact relevant to our opinion, we have relied exclusively, without independent

Dashiell J. Shannahan

Joyce C. Shannahan

Page 2

March 3/, 1998

verification or investigation, upon the above-referenced, instruments, certificates, records, and other documents, including the accuracy and completeness of the representations, warranties, and covenants contained in the Merger Agreement and certificates delivered to and by you in connection with the Merger Agreement and in other certificates of persons on whom we believe we are justified in relying. As to paragraph 2, we express no opinion as to any liens, charges, or encumbrances that may be imposed by actions or liabilities of persons other than the Purchaser or its officers and employees.

We express no opinion as to the laws of any jurisdiction other than the federal laws of the United States of America and the Maryland General Corporation Law.

Based upon and subject to the foregoing, we are of the opinion that:

1. The Purchaser is a corporation validly existing and in good standing under the laws of the State of Delaware.

2. The shares of Chesapeake Common Stock, par value \$0.4867 per share, to be issued pursuant to the Merger Agreement (the "Shares") have been duly authorized, and upon issuance in accordance with the terms of the Merger Agreement, will be validly issued, fully paid and nonassessable and will be delivered free and clear of all liens, charges and encumbrances of any kind or nature and such issuance will not be in violation of any preemptive rights. The issuance of the Shares in accordance with the Merger Agreement is exempt from the registration requirements of the Securities Act of 1933, as amended.


3. The Purchaser has the corporate power and authority to enter into the Merger Agreement and to consummate the transactions contemplated thereby. The execution and delivery of the Merger Agreement by the Purchaser and the consummation of the transactions contemplated thereby have been duly authorized by the requisite corporate action on the part of the Purchaser. The Merger Agreement has been executed and delivered by the Purchaser and is a valid and binding obligation of the Purchaser, enforceable against the Purchaser in accordance with its terms, except to the extent that enforcement thereof may be limited by (a) bankruptcy, insolvency, reorganization, moratorium or other similar laws now or hereafter in effect relating to creditors' rights generally and (b) general principles of equity (regardless of whether enforceability is considered in a proceeding at law or in equity).

Dashiell J. Shannahan  
Joyce C. Shannahan  
Page 3  
March 31, 1998

4. The execution, delivery and performance of the Merger Agreement by the Purchaser will not result in a breach or violation of any provision of the Certificate of Incorporation or Bylaws of the Purchaser.

This letter is furnished solely for your benefit in connection with the Merger Agreement and may not be used for any other purpose and may not be circulated to or relied on by any other person, without our written consent. This opinion is effective as of the date hereof, and we hereby disclaim any obligation to supplement this opinion for any changes that may occur hereafter with respect to any matters of fact or law addressed herein.

Sincerely yours,



Victor H. Laws, III

SCHMITTINGER AND RODRIGUEZ, P.A.

LAWYERS

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March 2, 1998

Delaware Public Service Commission  
Cannon Building, Suite 100  
861 Silver Lake Boulevard  
Dover, DE 19904

RE: Application of Chesapeake Utilities Corporation  
For The Approval of Issuance of Stock

Dear Commissioners:

We are Delaware counsel for Chesapeake Utilities Corporation ("Chesapeake") in connection with Chesapeake's application for Commission approval of the issuance of approximately 33,000 shares of Chesapeake common stock, pursuant to 26 Del. C. §215.

We are familiar with the terms, interpretation, and application of 26 Del. C. §215 which sets forth the required, but limited, findings to be made by the Commission in its consideration of such a proposed issue. We note the limited scope of Commission review, as determined by the Delaware Supreme Court in the Diamond State Telephone Company case, 367 A.2d 644 (1976). Specifically, in the Diamond State Telephone Company case, the Delaware Supreme Court held that the powers legislated to the Commission pursuant to 26 Del. C. §215 were intended to be applied in cases of a proposed issuance of stock for an inadequate consideration or for some other improper purpose. In Diamond State, the Delaware Supreme Court stated that in the absence of a showing of improper consideration, fraud, bad faith, or self-dealing on the part of the members of a utility's board of directors in their decision to issue shares of stock for the purpose of raising needed funds, it would be improper for the Commission to substitute its judgment for that of the board of directors.

Delaware Public Service Commission  
March 2, 1998  
Page 2

Based upon our knowledge of the applicable statute, and its regulatory and judicial interpretation and application, it is our opinion that the proposed issuance of approximately 33,000 shares of Chesapeake common stock has been duly authorized and is valid and in accordance with law, subject, of course, to the approval of the Public Service Commission pursuant to 26 Del. C. §215, any necessary approval on the part of the Florida Public Service Commission, and satisfactory compliance by Chesapeake with all applicable federal securities laws.

It is also our opinion, based upon the statement of Chesapeake's intended purpose for issuing said stock, that the subject stock issue is for a proper purpose, and is consistent with the public interest, by enabling Chesapeake to acquire Sam Shannahan Well Company, Inc.

Accordingly, it is our opinion that Chesapeake's pending application for Commission approval pursuant to 26 Del. C. §215 fully complies with the limited statutory requirements and findings necessary for Commission approval.

Sincerely yours,

SCHMITTINGER & RODRIGUEZ, P.A.

BY: 

WILLIAM A. DENMAN, ESQUIRE

WAD:pmw

## SCHMITTINGER AND RODRIGUEZ, P.A.

## LAWYERS

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April 29, 1998

Delaware Public Service Commission  
 Cannon Building, Suite 100  
 861 Silver Lake Boulevard  
 Dover, DE 19904

RE: Application of Chesapeake Utilities Corporation  
 For The Approval of Issuance of Stock

Dear Commissioners:

We are Delaware counsel for Chesapeake Utilities Corporation ("Chesapeake") in connection with Chesapeake's application for Commission approval of the issuance of approximately 475,000 shares of Chesapeake common stock, pursuant to 26 Del. C. §215.

We are familiar with the terms, interpretation, and application of 26 Del. C. §215 which sets forth the required, but limited, findings to be made by the Commission in its consideration of such a proposed issue. We note the limited scope of Commission review, as determined by the Delaware Supreme Court in the Diamond State Telephone Company case, 367 A.2d 644 (1976). Specifically, in the Diamond State Telephone Company case, the Delaware Supreme Court held that the powers legislated to the Commission pursuant to 26 Del. C. §215 were intended to be applied in cases of a proposed issuance of stock for an inadequate consideration or for some other improper purpose. In Diamond State, the Delaware Supreme Court stated that in the absence of a showing of improper consideration, fraud, bad faith, or self-dealing on the part of the members of a utility's board of directors in their decision to issue shares of stock for the purpose of raising needed funds, it would be improper for the Commission to substitute its judgment for that of the board of directors.

Delaware Public Service Commission  
April 29, 1998  
Page 2

Based upon our knowledge of the applicable statute, and its regulatory and judicial interpretation and application, it is our opinion that the proposed issuance of approximately 475,000 shares of Chesapeake common stock has been duly authorized and is valid and in accordance with law, subject, of course, to the approval of the Public Service Commission pursuant to 26 Del. C. §215, any necessary approval on the part of the Florida Public Service Commission, and satisfactory compliance by Chesapeake with all applicable federal securities laws.

It is also our opinion, based upon the statement of Chesapeake's intended purpose for issuing said stock, that the subject stock issue is for a proper purpose, and is consistent with the public interest, by enabling Chesapeake to acquire Xeron, Inc.

Accordingly, it is our opinion that Chesapeake's pending application for Commission approval pursuant to 26 Del. C. §215 fully complies with the limited statutory requirements and findings necessary for Commission approval.

Sincerely yours,

SCHMITTINGER & RODRIGUEZ, P.A.

BY:

  
WILLIAM A. DENMAN, ESQUIRE

WAD:pmw

---

**SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

---

**FORM 10-K**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934**

For the Fiscal Year Ended: December 31, 1997      Commission File Number: 001-11590

**CHESAPEAKE UTILITIES CORPORATION**

(Exact name of registrant as specified in its charter)

State of Delaware  
(State or other jurisdiction of  
incorporation or organization)

51-0064146  
(I.R.S. Employer  
Identification No.)

909 Silver Lake Boulevard, Dover, Delaware  
(Address of principal executive offices)

19904  
(Zip Code)

Registrant's telephone number, including area code: 302-734-6799

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of each class</u>	<u>Name of each exchange on which registered</u>
Common Stock - par value per share \$.4867	New York Stock Exchange, Inc.

Securities registered pursuant to Section 12(g) of the Act:

8.25% Convertible Debentures Due 2014  
(Title of class)

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendments to this Form 10-K. [X]

As of March 20, 1998, 4,543,695 shares of common stock were outstanding. The aggregate market value of the common shares held by non-affiliates of Chesapeake Utilities Corporation, based on the last trade price on March 20, 1997, as reported by the New York Stock Exchange, was approximately \$67 million.

**DOCUMENTS INCORPORATED BY REFERENCE**

DOCUMENTS  
Definitive Proxy Statement dated March 30, 1998

PART OF FORM 10-K  
Part III

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**CHESAPEAKE UTILITIES CORPORATION**  
**FORM 10-K**

**YEAR ENDED DECEMBER 31, 1997**

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## **PART I**

### **Item 1. Business**

#### **(a) General Development of Business**

Chesapeake Utilities Corporation (“Chesapeake” or “the Company”) is a diversified utility company engaged in natural gas distribution and transmission, propane distribution and advanced information services.

Chesapeake’s three natural gas distribution divisions serve approximately 35,800 residential, commercial and industrial customers in southern Delaware, Maryland’s Eastern Shore and Central Florida. The Company’s natural gas transmission subsidiary, Eastern Shore Natural Gas Company (“Eastern Shore”), operates a 271-mile interstate pipeline system that transports gas from various points in Pennsylvania to the Company’s Delaware and Maryland distribution divisions, as well as to other utilities and industrial customers in Delaware and on the Eastern Shore of Maryland. The Company’s propane segment serves approximately 34,000 customers in southern Delaware and on the Eastern Shore of Maryland and Virginia. The advanced information services segment provides software services and products to a wide variety of customers and clients.

#### **(b) Financial Information about Industry Segments**

Financial information by business segment is included in Item 7 under the heading Notes to Consolidated Financial Statements.

#### **(c) Narrative Description of Business**

The Company is engaged in four primary business activities: natural gas transmission, natural gas distribution, propane distribution and advanced information services. In addition to the four primary groups, Chesapeake has three subsidiaries engaged in other service related businesses.

##### ***(i) (a) Natural Gas Transmission***

Eastern Shore, the Company’s wholly owned transmission subsidiary, operates an interstate natural gas transportation and provides contract storage services for affiliated and non-affiliated companies through an integrated gas pipeline extending from southeastern Pennsylvania to Delaware and the Eastern Shore of Maryland. During 1997, Eastern Shore implemented open access transportation services. Eastern Shore now provides transportation services, contract storage services as well as purchasing and selling small amounts of gas for system balancing purposes (“swing gas”). Eastern Shore’s rates are subject to regulation by the Federal Energy Regulatory Commission (“FERC”).

##### ***Adequacy of Resources***

With the implementation of open access effective November 1, 1997, Eastern Shore released, through the permanent release mechanism of its upstream service providers tariffs, various levels of firm transportation capacity and contract storage service to customers. Eastern Shore retained contracts with Transcontinental Gas Pipe Line Corporation (“Transco”) for 4,916 thousand cubic feet (“Mcf”) firm transportation capacity, expiring in 2005, and three firm storage services providing peak day entitlements of 7,046 Mcf.

Eastern Shore also retained contracts with Columbia Gas Transportation (“Columbia”) for services, including: firm transportation capacity of 869 Mcf per day, which expires in 2018; storage service providing a peak day entitlement of 1,111 Mcf and total capacity of 53,738 Mcf, expiring in 2004; and firm storage service providing peak day entitlements of 563 Mcf and a total capacity of 50,686 Mcf, which expires in 2018. Eastern Shore retained the firm transportation capacity to provide swing transportation service to a limited number of customers that requested this service. Prior to open access, Eastern Shore had firm contracts with three interstate pipelines for transportation and storage services coupled with firm contracts for natural gas supply with five suppliers providing a maximum firm daily capacity of 20,469 Mcf.

### ***Competition***

Under this open access environment, interstate pipeline companies have unbundled the traditional components of their service — gas gathering, transportation and storage — from the sale of the commodity. Pipelines that choose to be merchants of gas must form separate marketing operations independent of their pipeline operations. Hence, gas marketers have developed as a viable option for many companies because they are providing expertise in gas purchasing along with collective purchasing capabilities which, when combined, may reduce end-user cost. Additional discussion on competition is included in Item 7 under the heading “Management’s Discussion and Analysis of Financial Condition and Results of Operations”.

### ***Rates and Regulation***

General. Eastern Shore is subject to regulation by the FERC as an interstate pipeline. The FERC regulates the provision of service, terms and conditions of service, and the rates and fees Eastern Shore can charge to its transportation customers. In addition, the FERC regulates the rates Eastern Shore is charged for transportation and transmission line capacity and services provided by Transco and Columbia.

### ***Regulatory Proceedings***

Delaware City Compressor Station Filing. In December 1995, Eastern Shore filed an application before the FERC pursuant to Sections 7(b) and (c) of the Natural Gas Act for a certificate of public convenience and necessity authorizing Eastern Shore to: (1) construct and operate a 2,170 horsepower compressor station in Delaware City, New Castle County, Delaware on a portion of its existing pipeline system known as the “Hockessin Line”, such new station to be known as the “Delaware City Compressor Station”; (2) construct and operate slightly less than one mile of 16-inch pipeline in Delaware City, New Castle County, Delaware to tie the suction side of the proposed Delaware City Compressor Station into the Hockessin Line; and (3) increase the maximum allowable operating pressure from 500 psig to 590 psig on 28.7 miles of Eastern Shore’s pipeline from Eastern Shore’s existing Bridgeville Compressor Station in Bridgeville, Sussex County, Delaware to its terminus in Salisbury, Wicomico County, Maryland.

In September 1996 the FERC issued its Final Order, which: (1) authorized Eastern Shore to construct and operate the facilities requested in its application; (2) authorized Eastern Shore to roll-in the cost of the facilities into its existing rates if the revenues from the increase in services exceed the cost associated with the expansion portion of the project; (3) denied Eastern Shore the authority to increase the level of sales and storage service it provides its customers until it completes its restructuring in its open access proceeding; and (4) authorized Eastern Shore to abandon the 100 Mcf per day of firm sale service, to one of its direct sale customers. The compressor facility and associated piping were needed to stabilize capacity on Eastern Shore’s system as a result of steadily declining inlet pressures at the Hockessin interconnect with Transcontinental Gas Pipe Line Corporation. Construction of the facilities started during the second half of 1996 and was completed during the first quarter of 1997.

Rate Case Filing. In October 1996 Eastern Shore filed for a general rate increase with the FERC. The filing proposed an increase in Eastern Shore’s jurisdictional rates that would generate additional annual operating revenue of approximately \$1.4 million. Eastern Shore also stated in the filing that it intended to use the cost-of-service submitted in the general rate increase filing to develop rates in the pending Open Access Docket. In September 1997, the FERC approved a rate increase of \$1.2 million.

Open Access Filing. In December 1995, Eastern Shore filed its abbreviated application for a blanket certificate of public convenience and necessity authorizing the transportation of natural gas on behalf of others. Eastern Shore proposed to unbundle the sales and storage services it had provided. Customers who had previously received firm sales and storage services on Eastern Shore (the “Converting Customers”) would receive entitlements to firm transportation service on Eastern Shore’s pipeline in a quantity equivalent to their existing service rights. Eastern Shore proposed to retain some of its pipeline entitlements and storage capacity for operational issues and to

facilitate “no-notice” (no prior notification required to receive service) transportation service on its pipeline system. Eastern Shore would release or assign to the remaining Converting Customers the firm transportation capacity, including contract storage, it held on its upstream pipelines so that the Converting Customers would be able to become direct customers of such upstream pipelines. Converting Customers who previously received bundled sales service having no-notice characteristics would have the right to elect no-notice firm transportation service.

In connection with the rate increase settlement, the issues pertaining to Eastern Shore operating as an open access pipeline were also settled in September 1997, with open access implementation occurring on November 1, 1997.

***(i) (b) Natural Gas Distribution***

Chesapeake distributes natural gas to approximately 35,800 residential, commercial and industrial customers in southern Delaware, the Salisbury and Cambridge, Maryland areas on Maryland’s Eastern Shore, and Central Florida. These activities are conducted through three utility divisions, one division in Delaware, another in Maryland and a third division in Florida. In 1993, the Company started natural gas supply management services in the state of Florida under the name of Peninsula Energy Services Company (“PESCO”).

Delaware and Maryland. The Delaware and Maryland divisions serve approximately 29,950 customers, of which approximately 26,860 are residential and commercial customers purchasing gas primarily for heating purposes. Annually, residential and commercial customers account for approximately 69% of the volume delivered by the divisions, and 79% of the divisions’ revenue. The divisions’ industrial customers purchase gas, primarily on an interruptible basis, for a variety of manufacturing, agricultural and other uses. Most of Chesapeake’s customer growth in these divisions comes from new residential construction using gas heating equipment.

Florida. The Florida division distributes natural gas to approximately 8,748 residential and commercial and 84 industrial customers in Polk, Osceola and Hillsborough Counties. Currently 42 of the division’s industrial customers, which purchase and transport gas on a firm and interruptible basis, account for approximately 90% of the volume delivered by the Florida division and 60% of the division’s annual natural gas and transportation revenues. These customers are primarily engaged in the citrus and phosphate industries and electric cogeneration. The Company’s Florida division also provides natural gas supply management services to compete in the open access environment. Currently, twenty-one customers receive such services, which generated gross margin of \$70,000 in 1997.

***Adequacy of Resources***

General. Chesapeake’s Delaware and Maryland utility divisions (“Delaware”, “Maryland” or “the Divisions”) have firm and interruptible contracts with four (4) interstate “open access” pipelines. The Divisions are directly interconnected with Eastern Shore and services upstream of Eastern Shore are contracted with Transco, Columbia, and Columbia Gulf Transmission Company (“Gulf”).

Delaware. Delaware’s contracts with Transco include: (a) firm transportation capacity of 8,663 dekatherms (“Dt”) per day, which expires in 2005; (b) firm transportation capacity of 311 Dt per day for December through February, expiring in 2006; and (c) firm storage service, providing a total capacity of 142,830 Dt, which expires in 1998.

Delaware’s contracts with Columbia include: (a) firm transportation capacity of 852 Dt per day, which expires in 2004; (b) firm transportation capacity of 1,132 Dt per day, which expires in 2017; (c) firm storage service, providing a peak day entitlement of 6,193 Dt and a total capacity of 298,195 Dt, which expires in 2004; and (d) firm storage service providing a peak day entitlement of 635 Dt and a total capacity of 57,139 Dt, expiring in 2017. Delaware’s contracts with Columbia for storage related transportation provide quantities that are equivalent to the peak day entitlement for the period of October through March and are equivalent to fifty percent (50%) of the peak

day entitlement for the period of April through September. The terms of the storage related transportation contracts mirror the storage services that they support.

Delaware's contract with Gulf, which expires in 2004, provides firm transportation capacity of 868 Dt per day for the period November through March and 798 Dt per day for the period April through October.

Delaware's contracts with Eastern Shore include: (a) firm transportation capacity of 23,494 Dt per day for the period December through February, 22,272 Dt per day for the months of November, March and April, and 13,196 Dt per day for the period May through October, with various expiration dates ranging from 2004 to 2017; (b) firm storage capacity under Eastern Shore's Rate Schedule GSS providing a peak day entitlement of 2,655 Dt and a total capacity of 131,370 Dt, which expires in 2013; (c) firm storage capacity under Eastern Shore's Rate Schedule LSS providing a peak day entitlement of 580 Dt and a total capacity of 29,000 Dt, which expires in 2013; and (d) firm storage capacity under Eastern Shore's Rate Schedule LGA providing a peak day entitlement of 911 Dt and a total capacity of 5,708 Dt, which expires in 2006. Delaware's firm transportation contracts with Eastern Shore also include Eastern Shore's provision of swing transportation service. This service includes: (a) firm transportation capacity of 1,846 Dt per day on Transco's pipeline system, retained by Eastern Shore, in addition to Delaware's Transco capacity referenced earlier and (b) an interruptible storage service under Transco's Rate Schedule ESS that supports a swing supply service provided under Transco's Rate Schedule FS.

Delaware currently has contracts for the purchase of firm natural gas supply with five (5) suppliers. These contracts provide the availability of a maximum firm daily entitlement of 10,958 Dt and the supplies are transported by Transco, Columbia, Gulf and Eastern Shore under Delaware's transportation contracts. The gas purchase contracts have various expiration dates.

Maryland Maryland's contracts with Transco include: (a) firm transportation capacity of 4,738 Dt per day, which expires in 2005; (b) firm transportation capacity of 155 Dt per day for December through February, expiring in 2006; and (c) firm storage service providing a total capacity of 33,120 Dt, which expires in 1998.

Maryland's contracts with Columbia include: (a) firm transportation capacity of 442 Dt per day, which expires in 2004; (b) firm transportation capacity of 908 Dt per day, which expires in 2017; (c) firm storage service providing a peak day entitlement of 3,142 Dt and a total capacity of 154,756 Dt, which expires in 2004; and (d) firm storage service providing a peak day entitlement of 521 Dt and a total capacity of 46,881 Dt, which expires in 2017. Maryland's contracts with Columbia for storage related transportation provide quantities that are equivalent to the peak day entitlement for the period October through March and are equivalent to fifty percent (50%) of the peak day entitlement for the period April through September. The terms of the storage related transportation contracts mirror the storage services that they support.

Maryland's contract with Gulf, which expires in 2004, provides firm transportation capacity of 590 Dt per day for the period November through March and 543 Dt per day for the period April through October.

Maryland's contracts with Eastern Shore include: (a) firm transportation capacity of 13,028 Dt per day for the period December through February, 12,304 Dt per day for the months of November, March and April, and 7,743 Dt per day for the period May through October; (b) firm storage capacity under Eastern Shore's Rate Schedule GSS providing a peak day entitlement of 1,428 Dt and a total capacity of 70,665 Dt, which expires in 2013; (c) firm storage capacity under Eastern Shore's Rate Schedule LSS providing a peak day entitlement of 309 Dt and a total capacity of 15,500 Dt, which expires in 2013; and (d) firm storage capacity under Eastern Shore's Rate Schedule LGA providing a peak day entitlement of 569 Dt and a total capacity of 3,560 Dt, which expires in 2006. Maryland's firm transportation contracts with Eastern Shore also include Eastern Shore's provision of swing transportation service. This service includes: (a) firm transportation capacity of 969 Dt per day on Transco's

pipeline system, retained by Eastern Shore, in addition to Maryland's Transco capacity referenced earlier and (b) an interruptible storage service under Transco's Rate Schedule ESS that supports a swing supply service provided under Transco's Rate Schedule FS.

Maryland currently has contracts for the purchase of firm natural gas supply with five (5) suppliers. These contracts provide the availability of a maximum firm daily entitlement of 6,243 Dt and the supplies are transported by Transco, Columbia, Gulf and Eastern Shore under Maryland's transportation contracts. The gas purchase contracts have various expiration dates. The Divisions use their firm supply sources to meet a significant percentage of their projected demand requirements. In order to meet the difference between firm supply and firm demand, Delaware and Maryland obtain gas supply on the "spot market" from various other suppliers that is transported by the upstream pipelines and delivered to the Divisions' interconnects with Eastern Shore as needed. The Company believes that Delaware and Maryland's available firm and "spot market" supply is ample to meet the anticipated needs of their customers.

Florida. The Florida division receives transportation service from Florida Gas Transmission Company ("FGT"), a major interstate pipeline. Chesapeake has contracts with FGT for: (a) daily firm transportation capacity of 20,523 Dt in May through September, 27,105 Dt in October, and 26,919 Dt in November through April under FGT's firm transportation service (FTS-1) rate schedule; (b) daily firm transportation capacity of 5,100 Dt in May through October, and 8,100 Dt in November through April under FGT's firm transportation service (FTS-2) rate schedule; and (c) daily interruptible transportation capacity of 20,000 Dt under FGT's interruptible transportation services (ITS-1) rate schedule. The firm transportation contract (FTS-1) expires on August 1, 2000 with the Company retaining a unilateral right to extend the term for an additional ten years. After the expiration of the primary or secondary term, Chesapeake has the right to first refuse to match the terms of any competing bids for the capacity. The firm transportation contract (FTS-2) expires on March 1, 2015. The interruptible transportation contract is effective until August 1, 2010 and month to month thereafter unless canceled by either party with thirty days notice.

The Florida division currently receives its gas supply from various suppliers. If needed, some supply is bought on the spot market; however, the majority is bought under the terms of two firm supply contacts with Natural Gas Clearinghouse and LG&E Energy Marketing. Availability of gas supply to the Florida division is also expected to be adequate under existing arrangements.

### ***Competition***

Competition with Alternative Fuels. Historically, the Company's natural gas distribution divisions have successfully competed with other forms of energy such as electricity, oil and propane. The principal consideration in the competition between the Company and suppliers of other sources of energy is price and, to a lesser extent, accessibility. All of the Company's divisions have the capability of adjusting their interruptible rates to compete with alternative fuels.

The divisions have several large volume industrial customers that have the capacity to use fuel oil as an alternative to natural gas. When oil prices decline, these interruptible customers convert to oil to satisfy their fuel requirements. Lower levels in interruptible sales occur when oil prices remain depressed relative to the price of natural gas. However, oil prices as well as the prices of other fuels are subject to change at any time for a variety of reasons; therefore, there is always uncertainty in the continuing competition among natural gas and other fuels. In order to address this uncertainty, the Company uses flexible pricing arrangements on both the supply and sales side of its business to maximize sales volumes.

To a lesser extent than price, availability of equipment and operational efficiency are also factors in competition among fuels, primarily in residential and commercial settings. Heating, water heating and other domestic or

commercial equipment is generally designed for a particular energy source, and especially with respect to heating equipment, the cost of conversion is a disincentive for individuals and businesses to change their energy source.

*Competition within the Natural Gas Industry.* FERC Order 636 enables all natural gas suppliers to compete for customers on an equal footing. Under this open access environment, interstate pipeline companies have unbundled the traditional components of their service — gas gathering, transportation and storage from the sale of the commodity. If they choose to be a merchant of gas, they must form a separate marketing operation independent of their pipeline operations. Hence, gas marketers have developed as a viable option for many companies because they are providing expertise in gas purchasing along with collective purchasing capabilities which, when combined, may reduce end-user cost.

Also resulting from an open access environment, the distribution division can be in competition with the interstate transmission company if the distribution customer is located close to the transmission company's pipeline. The customers at risk are usually large volume commercial and industrial customers with the financial resources and capability to bypass the distribution division. In certain situations the distribution divisions may adjust rates and serves for these customers to retain their business.

### ***Rates and Regulation***

*General.* Chesapeake's natural gas distribution divisions are subject to regulation by the Delaware, Maryland and Florida Public Service Commissions with respect to various aspects of the Company's business, including the rates for sales to all of their customers in each jurisdiction. All of Chesapeake's firm distribution rates are subject to purchased gas adjustment clauses, which match revenues with gas costs and normally allow eventual full recovery of gas costs. Adjustments under these clauses require periodic filings and hearings with the relevant regulatory authority, but do not require a general rate proceeding. Rates on interruptible sales by the Florida division are also subject to purchased gas adjustment clauses.

Management monitors the rate of return in each jurisdiction in order to ensure the timely filing of rate adjustment applications.

### ***Regulatory Proceedings***

*Maryland.* In July 1995, Chesapeake's Maryland division filed an application with the Maryland Public Service Commission ("MPSC") requesting a rate increase of \$1,426,711 or 17.09%. The two largest components of the increase were attributable to environmental costs and a new customer information system, implemented in 1995.

On November 30, 1995, the MPSC issued an order approving a settlement proposal of a \$975,000 increase in annual base rates effective for gas provided on or after December 1, 1995. As required in the settlement of the rate case, the Company filed a cost of service study with the MPSC in June 1996. The purpose of a cost of service study was to allocate revenue among customer or rate classifications. The filing, which included proposals for restructuring sales services that more closely reflect the cost of serving commercial and industrial customers, the unbundling of gas costs from distribution system costs, revisions to sharing of interruptible margins between firm ratepayers and the Company and new services that would allow customers using more than 30,000 Ccf of gas per year to purchase gas from suppliers other than the Company.

After negotiations with MPSC staff and other interested parties, a settlement was reached on most sales service issues and the Commission approved a proposed order in March 1997. The settlement includes: (1) class revenue requirements and restructured sales services which provide for separate firm commercial and industrial rate schedules for general service, medium volume, large volume and high load factor customer groups; (2) unbundling of gas costs from distribution charges; (3) a new gas cost recovery mechanism, which utilizes a projected period under which the fixed cost portion of the gas rate will be forecasted on an annual basis and the commodity cost

portion of the gas rate will be estimated quarterly, based on projected market prices; and (4) interruptible margins will continue to be shared, 90% to customers and 10% to the Company, but distribution costs incurred for incremental load additions can be recovered with carrying charges utilizing 100% of the incremental margin if the payback period is within three years.

At the request of MPSC staff, consideration of the new transportation services were postponed until Eastern Shore's open access filing was settled with the FERC.

Delaware. In April 1995, Chesapeake's Delaware division filed an application with the Delaware Public Service Commission ("DPSC") requesting a rate increase of \$2,751,000 or 14% over current rates. The largest component, one-third of the total requested increase, was attributable to projected costs associated with the remediation proposed by the Environmental Protection Agency ("EPA") of the site of a former coal gas manufacturing plant operated in Dover, Delaware. The Company and the DPSC agreed to separate the environmental recovery from the rate increase so each could be addressed individually. In December 1995, the DPSC approved an order authorizing a \$900,000 increase to base rates effective January 1, 1996.

In December 1995, the DPSC approved a recovery of environmental costs associated with the Dover Gas Light Site by means of a rider (supplement) to base rates. The DPSC approved a rider effective January 1, 1996 to recover over five years all unrecovered environmental costs through September 30, 1995 offset by the deferred tax benefit of these costs. The deferred tax benefit equals the projected cashflow savings realized by the Company in connection with a reduced income tax liability due to the possibility of accelerated deduction allowed on certain environmental costs when incurred. Each year, the rider rate will be calculated based on the amortization of expenses for previous years. The advantage of the environmental rider is that it is not necessary to file a rate case every year to recover expenses.

In December 1995, Chesapeake's Delaware division filed its rate design proposal with the DPSC to initiate Phase II of this proceeding. The principal objective of the filing was to prepare the Company for an increasingly competitive environment anticipated when Eastern Shore becomes an open access pipeline. This initial filing proposed new rate schedules for commercial and industrial sales service, individual pricing for interruptible negotiated contract rates, a modified purchased gas cost recovery mechanism and a natural gas vehicle tariff.

In May 1996, Delaware division filed its proposal relating to transportation and balancing services with the DPSC, which proposed that transportation of customer-owned gas be available to all commercial and industrial customers with annual consumption over 3,000 Mcf per year.

In February 1997, the DPSC approved an order authorizing new service offerings and rate design for services rendered on and after March 1, 1997. The approved changes include: (1) restructured sales services which provide commercial and industrial customers with various service classifications such as general service, medium volume, large volume and high load factor services; (2) a modified purchased gas cost recovery mechanism which takes into consideration the unbundling of gas costs from distribution charges as well as charging certain firm service classifications different gas cost rates based on the service classification's load factor; (3) the implementation of a mechanism for sharing interruptible, capacity release and off-system sales margins between firm sales customers and the Company, with changing margin sharing percentages based on the level of total margin; and (4) a provision for transportation and balancing services for commercial and industrial customers with annual consumption over 30,000 Ccf per year to transport customer-owned gas on the Company's distribution system.

Florida. On November 26, 1997, the Florida Division filed a request with the Florida Public Service Commission (FPSC) in Docket No. 971559-GU, for a Limited Proceeding to Restructure Rates and for Approval of Gas Transportation Agreements. The Florida Division has entered into Gas Transportation Contracts with its two largest



customers which resulted in retaining these two customers on the Company's distribution system at rates lower than previously achieved. As a result of this reduction in revenue, the Company has proposed in its application to restructure rates for its remaining customers to more closely reflect the cost of service for each rate class and to recover the level of revenues previously generated by the two Contract customers.

The Company's restructuring proposal is revenue neutral. Approval of this request would not result in additional revenues to the Company; however, FPSC approval would enable the Company to retain its two largest customers while providing the Company with the opportunity to achieve its FPSC authorized rate of return.

FPSC Staff issued their recommendation in this docket on March 12, 1998. The Commission voted to approve the Company's restructuring proposal on March 24, 1998. A Commission Order in this docket is expected April 14, 1998.

***(i) (c) Propane Distribution***

Chesapeake's propane distribution group consists of Sharp Energy, Inc. ("Sharp Energy"), a wholly owned subsidiary of Chesapeake, its wholly owned subsidiary, Sharpgas, Inc. ("Sharpgas") and Tri-County Gas Company, Inc. ("Tri-County") a wholly owned subsidiary of Chesapeake.

On March 6, 1997, Chesapeake acquired all of the outstanding shares of Tri-County a family-owned and operated propane distribution business located in Salisbury and Pocomoke, Maryland. The combined operations of the Company and Tri-County served approximately 34,000 propane customers on the Delmarva Peninsula and delivered approximately 27 million retail and wholesale gallons of propane during 1997.

The propane distribution business is affected by many factors such as seasonality, the absence of price regulation and competition among local providers.

Propane is a form of liquefied petroleum gas which is typically extracted from natural gas or separated during the crude oil refining process. Although propane is gaseous at normal pressures, it is easily compressed into liquid form for storage and transportation. Propane is a clean-burning fuel, gaining increased recognition for its environmental superiority, safety, efficiency, transportability and ease of use relative to alternative forms of energy. Propane is sold primarily in suburban and rural areas which are not served by natural gas pipelines. Demand is typically much higher in the winter months and is significantly affected by seasonal variations, particularly the relative severity of winter temperatures, because of its use in residential and commercial heating.

***Adequacy of Resources***

Sharp Energy and Tri-County purchase propane primarily from suppliers, including major domestic oil companies and independent producers of gas liquids and oil. Supplies of propane from these and other sources are readily available for purchase by the Company. Supply contracts generally include minimum (not subject to a take-or-pay premiums) and maximum purchase provisions.

Sharp Energy and Tri-County use trucks and railroad cars to transport propane from refineries, natural gas processing plants or pipeline terminals to the Company's bulk storage facilities. From these facilities, propane is delivered in portable cylinders or by "bobtail" trucks, owned and operated by the Companies, to tanks located at the customer's premises.

***Competition***

Sharp Energy and Tri-County 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 local because distributors located in close proximity to customers incur lower costs of providing service.

Propane competes with both fuel oil and electricity as an energy source. Propane competes with fuel oil based on its cleanliness and environmental advantages. Propane is also typically less expensive than both fuel oil and electricity, based on equivalent BTU value. Since natural gas has historically been less expensive than propane, propane is generally not distributed in geographic areas serviced by natural gas pipeline or distribution systems.

The Company's propane distribution activities are not subject to any federal or state pricing regulation. Transport operations are subject to regulations concerning the transportation of hazardous materials promulgated under the Federal Motor Carrier Safety Act, which is administered by the United States Department of Transportation and enforced by the various states in which such operations take place. Propane distribution operations are also subject to state safety regulations relating to "hook-up" and placement of propane tanks.

The Company's propane operations are subject to all operating hazards normally associated with the handling, storage and transportation of combustible liquids, such as the risk of personal injury and property damage caused by fire. The Company carries general liability insurance in the amount of \$35,000,000 per occurrence, but there is no assurance that such insurance will be adequate.

***(i) (d) Advanced Information Services***

Chesapeake's advanced information services segment is comprised of United Systems, Inc. ("USI") and Capital Data Systems, Inc. ("CDS"), both wholly owned subsidiaries of the Company. CDS provided programming support for application software, until the first quarter of 1997, at which time it disposed of substantially all of its assets.

USI is an Atlanta-based company that primarily provides support for users of PROGRESS™, a fourth generation computer language and Relational Database Management System. USI offers consulting, training, software development "tools" and customer software development for its client base, which includes many large domestic and international corporations.

***Competition***

The advanced information services businesses face significant competition from a number of larger competitors having substantially greater resources available to them than the Company. In addition, changes in the advanced information services businesses are occurring rapidly, which could adversely impact the markets for the Company's products and services.

***(i) (e) Other Subsidiaries***

Skipjack, Inc. ("Skipjack") and Chesapeake Investment Company ("Chesapeake Investment"), are wholly owned subsidiaries of Chesapeake Service Company. Skipjack owns and leases to affiliates, two office buildings in Dover, Delaware. Chesapeake Investment is a Delaware affiliated investment company.

On March 6, 1997, in connection with the acquisition of Tri-County, the Company acquired Eastern Shore Real Estate, Inc. ("ESR"), which became a wholly owned subsidiary of Chesapeake Service Company. ESR owns and leases office buildings to affiliates and external companies.

***(ii) Seasonal Nature of Business***

Revenues from the Company's residential and commercial natural gas sales and from its propane distribution activities are affected by seasonal variations, since the majority of these sales are to customers using the fuels for heating purposes. Revenues from these customers are accordingly affected by the mildness or severity of the heating season.

**(iii) Capital Budget**

A discussion of capital expenditures by business segment is included in Item 7 under the heading "Liquidity and Capital Resources".

**(iv) Employees**

The Company has 397 employees, including 114 in natural gas distribution, nine in natural gas transmission, 131 in propane distribution and 63 in advanced information services. The remaining 80 employees are considered general and administrative and include officers of the Company and marketing, engineering, treasury, accounting, data processing, planning, human resources and other administrative personnel. The acquisition of Tri-County added 43 employees to the total number of employees of the Company.

**Item 2. Properties**

**(a) General**

The Company owns offices and operates facilities in Pocomoke, Salisbury, Cambridge, and Princess Anne, Maryland; Dover, Seaford, Laurel and Georgetown, Delaware; and Winter Haven, Florida, and rents office space in Dover, Delaware; Plant City, Florida; Chincoteague and Belle Haven, Virginia; Easton and Pocomoke, Maryland; Detroit, Michigan; and Atlanta, Georgia. In general, the properties of the Company are adequate for the uses for which they are employed. Capacity and utilization of the Company's facilities can vary significantly due to the seasonal nature of the natural gas and propane distribution businesses.

**(b) Natural Gas Distribution**

Chesapeake owns over 542 miles of natural gas distribution mains (together with related service lines, meters and regulators) located in its Delaware and Maryland service areas, and 469 miles of such mains (and related equipment) in its Central Florida service areas. Chesapeake also owns facilities in Delaware and Maryland for propane-air injection during periods of peak demand. A portion of the properties constituting Chesapeake's distribution system are encumbered pursuant to Chesapeake's First Mortgage Bonds.

**(c) Natural Gas Transmission**

Eastern Shore owns approximately 271 miles of transmission lines extending from Parkesburg, Pennsylvania to Salisbury, Maryland. Eastern Shore also owns three compressor stations located in Delaware City, Delaware, Daleville, Pennsylvania and Bridgeville, Delaware. The Delaware City compressor facility and associated piping are needed to stabilize capacity on Eastern Shore's system as a result of steadily declining inlet pressures at the Hockessin interconnect with Transcontinental Gas Pipe Line Corporation. The Daleville station is used to increase Columbia supply pressures to match Transco supply pressures, and to increase Eastern Shore's pressures in order to serve Eastern Shore's firm customers' demands, including those of Chesapeake's Delaware and Maryland divisions. The Bridgeville station is being used to provide increased pressures required to meet demands on the system.

**(d) Propane Distribution**

Sharpgas and Tri-County own bulk propane storage facilities with an aggregate capacity of 1.9 million gallons at 33 plant facilities in Delaware, Maryland and Virginia, located on real estate they either own or lease.

**Item 3. Legal Proceedings**

The Company and its subsidiaries are 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 of the Company.

## **Environmental**

### **(a) Dover Gas Light Site**

In 1984, the State of Delaware notified the Company that a parcel of land it purchased in 1949 from Dover Gas Light Company, a predecessor gas company, contained hazardous substances. The State also asserted that the Company is responsible for any clean-up and prospective environmental monitoring of the site. The Delaware Department of Natural Resources and Environmental Control ("DNREC") investigated the site and surroundings, finding coal tar residue and some ground-water contamination.

In October 1989, the Environmental Protection Agency Region III ("EPA") listed the Dover Site on the National Priorities List under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA" or "Superfund"). At that time under CERCLA, both the State of Delaware and the Company were named as potentially responsible parties ("PRPs") for clean-up of the site.

The EPA issued the site Record of Decision ("ROD") dated August 16, 1994. The remedial action selected by the EPA in the ROD addressed the ground-water contamination with a combination of hydraulic containment and natural attenuation. Remediation selected for the soil at the site was to meet stringent cleanup standards for the first two feet of soil and less stringent standards for the soil below two feet. The ROD estimated the costs of selected remediation of ground-water and soil at \$2.7 million and \$3.3 million, respectively.

In May 1995, EPA issued an order to the Company under section 106 of CERCLA (the "Order"), which required the Company to fund or implement the ROD. The Order was also issued to General Public Utilities Corporation, Inc. ("GPU"), which both EPA and the Company believe is liable under CERCLA. Other PRPs such as the State of Delaware were not ordered to perform the ROD. EPA may seek judicial enforcement of its Order, as well as significant financial penalties for failure to comply. Although notifying EPA of objections to the Order, the Company agreed to comply. GPU informed EPA that it did not intend to comply with the Order.

In March 1995, the Company commenced litigation against the State of Delaware for contribution to the remedial costs being incurred to carry out the ROD. In December of 1995, this case was dismissed without prejudice based on a settlement agreement between the parties (the "Settlement"). Under the Settlement, the State agreed to support the Company's proposal to reduce the soil remedy for the site, described below, to contribute \$600,000 toward the cost of implementing the ROD and to reimburse the EPA for \$400,000 in oversight costs. The Settlement is contingent upon a formal settlement agreement between EPA and the State of Delaware. Upon satisfaction of all conditions of the Settlement, the litigation will be dismissed with prejudice.

In June 1996, the Company initiated litigation against GPU for contribution to the remedial costs incurred by Chesapeake in connection with complying with the ROD. At this time, management cannot predict the outcome of the litigation or the amount, if any, of proceeds to be received.

In July 1996, the Company began the design phase of the ROD, on-site pre-design and investigation. A pre-design investigation report ("the report") was filed in October 1996 with the EPA. The report, which required EPA approval, provided up to date status on the site, which the EPA used to determine if the remedial design selected in the ROD was still the appropriate remedy.

In the report, the Company proposed a modification to the soil clean-up remedy selected in the ROD to take into account an existing land use restriction banning future development at the site. In April of 1997, the EPA issued a fact sheet stating that the EPA was considering the proposed modification. The fact sheet included an overall cost estimate of \$5.7 million for the proposed modified remedy and a new overall cost estimate of \$13.2 million for the remedy selected in the ROD. On August 28, 1997, the EPA issued a Proposed Plan to modify the current clean-up plan that would involve: (1) excavation of off-site thermal treatment of the contents of the former subsurface gas holders; (2) implementation

of soil vaporization extraction; (3) pavement of the parking lot; and (4) use of institutional controls that would restrict future development of the Site. The overall estimated clean-up cost of the Site under the proposed plan was \$4.2 million, as compared to EPA's estimate of the current clean-up plan at \$13.2 million. In January 1998, the EPA issued a revised ROD, which modified the soil remediation to conform to the proposed plan and included the estimated clean-up costs of \$4.2 million.

The Company is currently engaged in investigations related to additional parties who may be PRPs. Based upon these investigations, the Company will consider suit against other PRPs. The Company expects continued negotiations with PRPs in an attempt to resolve these matters.

The Company adjusted its accrued liability recorded with respect to the Dover Site to \$4.2 million. This amount reflects the EPA's estimate, as stated in the ROD issued in 1998 for remediation of the site according to the ROD. The recorded liability may be adjusted upward or downward as the design phase progresses and the Company obtains construction bids for performance of the work. The Company has also recorded a regulatory asset of \$4.2 million, corresponding to the recorded liability. Management believes that in addition to the \$600,000 expected to be contributed by the State of Delaware under the Settlement, the Company will be equitably entitled to contribution from other responsible parties for a portion of the expenses to be incurred in connection with the remedies selected in the ROD. Management also believes that the amounts not so contributed will be recoverable in the Company's rates.

As of December 31, 1997, the Company has incurred approximately \$5.0 million in costs relating to environmental testing and remedial action studies. In 1990, the Company entered into settlement agreements with a number of insurance companies resulting in proceeds to fund actual environmental costs incurred over a five to seven-year period. In December 1995, the Delaware Public Service Commission, authorized recovery of all unrecovered environmental cost incurred by a means of a rider (supplement) to base rates, applicable to all firm service customers. The costs would be recovered through a five-year amortization offset by the deferred tax benefit associated with those environmental costs. The deferred tax benefit equals the projected cashflow savings realized by the Company in connection with a reduced income tax liability due to the possibility of accelerated deduction allowed on certain environmental costs when incurred. Each year a new rider rate is calculated to become effective December 1. The rider rate is based on the amortization of expenditures through September of the filing years plus amortization of expenses from previous years. The advantage of the rider is that it is not necessary to file a rate case every year to recover expenses incurred. As of December 31, 1997, the unamortized balance and amount of environmental costs not included in the rider, effective January 1, 1998 was \$2.1 million and \$190,000, respectively. With the rider mechanism established, it is management's opinion that these costs and any future cost, net of the deferred income tax benefit, will be recoverable in rates.

#### **(b) Salisbury Town Gas Light Site**

In cooperation with the Maryland Department of the Environment ("MDE"), the Company has completed assessment, construction and has begun remediation of the Salisbury manufactured gas plant site. The assessment determined that there was localized contamination of ground-water. A remedial design report was submitted to MDE in November 1990 and included a proposal to monitor, pump and treat any contaminated ground-water on-site. Through negotiations with the MDE, the remedial action work plan was revised with final approval from MDE obtained in early 1995. The remediation process for ground-water was revised from pump-and-treat to Air Sparging and Soil-Vapor Extraction, resulting in a substantial reduction in overall costs. During 1996, the Company completed construction and began remediation procedures at the Salisbury site and has been reporting the remediation and monitoring results to the Maryland Department of the Environment on an ongoing basis.

The cost of remediation is estimated to range from \$140,000 to \$190,000 per year for operating expenses. Based on these estimated costs, the Company recorded both a liability and a deferred regulatory asset of \$665,000 on December 31, 1997, to cover the Company's projected remediation costs for this site. The liability payout for this site is expected to be over a five-year period. As of December 31, 1997, the Company has incurred approximately \$2.4 million for

remedial actions and environmental studies and has charged such costs to accumulated depreciation. In January 1990, the Company entered into settlement agreements with a number of insurance companies resulting in proceeds to fund actual environmental costs incurred over a three to five-year period beginning in 1990. The final insurance proceeds were requested and received in 1992. In December 1995, the Maryland Public Service Commission approved recovery of all environmental cost incurred through September 30, 1995 less amounts previously amortized and insurance proceeds. The amount approved for a 10-year amortization was \$964,251. Of the \$2.4 million in costs reported above, approximately \$597,000 has not been recovered through insurance proceeds or received ratemaking treatment. It is management's opinion that these costs incurred and future costs incurred, if any, will be recoverable in rates.

**(c) Winter Haven Coal Gas Site**

In May 1996, the Company filed an Air Sparging and Soil Vapor Extraction Pilot Study Work Plan for the Winter Haven site with the Florida Department of Environmental Protection ("FDEP"). The Work Plan described the Company's proposal to undertake an Air Sparging and Soil Vapor Extraction ("AS/SVE") pilot study to evaluate at the site. After discussions with the FDEP, the Company filed a modified AS/SVE Pilot Study Work Plan, scope of work to complete the site assessment activities and a report describing a limited sediment investigation performed recently. The Company will be awaiting FDEP's comments to the modified Work Plan. It is not possible to determine whether remedial action will be required by FDEP and, if so, the cost of such remediation.

The company has spent and received ratemaking treatment of approximately \$678,000 on these investigations as of September 30, 1997. The Company has been allowed by the Florida Public Service Commission to continue to accrue for future environmental costs. At September 30, 1997, the Company had \$432,000 accrued. It is management's opinion that future costs, if any, will be recoverable in rates.

**Item 4. Submission of Matters to a Vote of Security Holders**

None

**Item 10. Executive Officers of the Registrant**

Information pertaining to the Executive Officers of the Company is as follows:

Ralph J. Adkins (age 55) Mr. Adkins is Chairman of the Board and Chief Executive Officer of Chesapeake. He has served as Chairman of the Board and Chief Executive Officer since August 1997. Prior to holding his present position, Mr. Adkins served as President and Chief Executive Officer, President and Chief Operating Officer, Executive Vice President, Senior Vice President, Vice President and Treasurer of Chesapeake. Mr. Adkins is also Chairman and Chief Executive Officer of Chesapeake Service Company, and Chairman and Chief Executive Officer of Sharp Energy, Inc., Tri-County Gas Company, Inc., Chesapeake Service Company and Eastern Shore Natural Gas Company, all wholly owned subsidiaries of Chesapeake. He has been a director of Chesapeake since 1989.

John R. Schimkaitis (age 50) Mr. Schimkaitis is President and Chief Operating Officer. He has served as President since August 1997. He previously served as Executive Vice President, Chief Financial Officer, Senior Vice President, Treasurer and Assistant Secretary. From 1983 to 1986, Mr. Schimkaitis was Vice President of Cooper & Rutter, Inc., a consulting firm providing financial services to the utility and cable industries. He was appointed as a director of Chesapeake in February 1996.

Michael P. McMasters (age 39) Mr. McMasters is Vice President, Chief Financial Officer and Treasurer of Chesapeake Utilities Corporation. He has served as Vice President, Chief Financial Officer and Treasurer since December 1996. He previously served as Vice President of Eastern Shore, Director of Accounting and Rates and Controller. From 1992 to May 1994, Mr. McMasters was employed as Director of Operations Planning for Equitable Gas Company.

Stephen C. Thompson (age 37) Mr. Thompson is Vice President of the Natural Gas Operations, as well as Vice President of Chesapeake Utilities Corporation. He has served as Vice President since May 1997. He has served as President, Vice President, Manager, Director of Gas Supply and Marketing and Superintendent of Eastern Shore and Regional Manager for the Florida distribution Operations.

Philip S. Barefoot (age 50) Mr. Barefoot joined Chesapeake as Division Manager of Florida Operations in July 1988. In May 1994 he was elected Vice President of Chesapeake Utilities Corporation. Prior to joining Chesapeake, he was employed by Peoples Natural Gas Company where he held the positions of Division Sales Manager, Division Manager and Vice President of Florence Operations.

Jeremy D. West (age 48) Mr. West joined Chesapeake as President of Sharp Energy in June 1990. In May 1992 he was elected Vice President of Chesapeake's Propane Operations and in May 1997, he was promoted to Vice President of Strategic Planning and Acquisitions. Prior to joining Chesapeake, he was employed by Columbia Propane Corporation, a subsidiary of Columbia Gas System, as Vice President of Marketing, and later, President of Columbia Propane Corporation. He has also serviced as Regional Manager of Suburban Propane.

## PART II

### Item 5. Market for the Registrant's Common Stock and Related Security Holder Matters

#### (a) Common Stock Dividends and Price Ranges:

The following table sets forth sale price and dividend information for each calendar quarter during the years December 31, 1997 and 1996:

Quarter Ended	High	Low	Close	Dividends Declared Per Share
<b>1997</b>				
March 31 .....	\$18.000 .....	\$16.500 .....	\$17.375 .....	\$0.2425
June 30 .....	17.500 .....	16.000 .....	17.000 .....	0.2425
September 30 .....	18.500 .....	16.250 .....	18.375 .....	0.2425
December 31 .....	21.750 .....	18.375 .....	20.500 .....	0.2425
<b>1996</b>				
March 31 .....	\$17.000 .....	\$14.500 .....	\$16.750 .....	\$0.2325
June 30 .....	17.875 .....	15.875 .....	16.000 .....	0.2325
September 30 .....	17.750 .....	15.125 .....	17.500 .....	0.2325
December 31 .....	18.000 .....	16.375 .....	16.875 .....	0.2325

The common stock of the Company trades on the New York Stock Exchange under the symbol "CPK".

#### (b) Approximate number of holders of common stock as of December 31, 1997:

Title of Class	Number of Shareholders of Record
Common stock, par value \$.4867	2,178

**(c) Dividends:**

During the years ended December 31, 1997 and 1996, cash dividends paid by Chesapeake have been declared each quarter, in the amounts set forth in the table above. During 1996 and 1995, Tri-County paid dividends of \$79,000 and \$592,000, respectively.

Indentures to the long-term debt of the Company and its subsidiaries contain a restriction that the Company cannot, until the retirement of its Series I Bonds, pay any dividends after December 31, 1988 which exceed the sum of \$2,135,188 plus consolidated net income recognized on or after January 1, 1989. As of December 31, 1997, the amounts available for future dividends permitted by the Series I covenant are \$14.6 million.

**(d)** On March 6, 1997, in conjunction with the acquisition of Tri-County Gas Company, Inc., the Company issued 639,000 shares of Company stock to William P. Schneider and James R. Schneider in reliance on the private placement exemption provided by Section 4(2) of the Securities Act of 1933 and Regulation D, thereunder.



## Item 6. Selected Financial Data

(dollars in thousands except stock data)					
For the Years Ended December 31,	1997	1996	1995	1994 <sup>(1)</sup>	1993 <sup>(1)</sup>
<b>Operating</b>					
Operating revenues	\$122,775	\$130,213	\$111,796	\$98,572	\$85,873
Operating income	\$8,559	\$10,110	\$10,067	\$7,227	\$6,311
Income before cumulative effect of change in accounting principle	\$5,683	\$7,605	\$7,594	\$4,460	\$3,914
Cumulative effect of change in accounting principle					\$58
Net income	\$5,683	\$7,605	\$7,594	\$4,460	\$3,972
<b>Balance Sheet</b>					
Gross plant	\$143,345	\$133,001	\$119,837	\$110,023	\$100,330
Net plant	\$99,517	\$93,570	\$84,589	\$75,313	\$69,794
Total assets	\$137,379	\$136,046	\$123,339	\$108,271	\$100,988
Long-term debt, net	\$38,226	\$28,984	\$31,619	\$24,329	\$25,682
Common stockholders' equity	\$50,336	\$47,537	\$42,582	\$37,063	\$34,878
Capital expenditures	\$11,381	\$14,837	\$12,887	\$10,653	\$10,064
<b>Common Stock</b>					
Basic earnings per share:					
Income before cumulative effect of change in accounting principle	\$1.27	\$1.72	\$1.75	\$1.23	\$1.10
Cumulative effect of change in accounting principle					\$0.02
Net income	\$1.27	\$1.72	\$1.75	\$1.23	\$1.12
Diluted earnings per share:					
Income before cumulative effect of change in accounting principle	\$1.24	\$1.67	\$1.70	\$1.20	\$1.08
Cumulative effect of change in accounting principle					\$0.02
Net income	\$1.24	\$1.67	\$1.70	\$1.20	\$1.10
Average shares outstanding	4,472,087	4,412,137	4,336,431	3,628,056	3,551,932
Cash dividends per share	\$0.97	\$0.93	\$0.90	\$0.88	\$0.86
Book value per share	\$11.18	\$10.71	\$9.77	\$10.15	\$9.76
Common equity/Total capitalization	56.80%	62.10%	57.40%	60.37%	57.59%
Return on equity	11.29%	16.00%	17.80%	12.03%	11.39%
<b>Other</b>					
Number of Employees	397	386	383	320	326
Number of Registered Stockholders	2,178	2,213	2,098	1,721	1,743
Heating Degree Days	4,418	4,717	4,593	4,398	4,705
Heating Degree Days (10-year average)	4,577	4,596	4,586	4,564	4,588

<sup>(1)</sup> 1994 and 1993 have not been restated to include the business combination with Tri-County Gas Company, Inc.

## **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### **Liquidity and Capital Resources**

The capital requirements of Chesapeake Utilities Corporation ("Chesapeake" or "the Company") reflect the capital-intensive nature of its business and are attributable principally to the construction program and the retirement of outstanding debt. The Company relies on cash generated from operations and short-term borrowing to meet normal working capital requirements and temporarily finance capital expenditures. During 1997, net cash provided by operating activities, used by investing activities and used by financing activities were \$12.3 million, \$12.4 million and \$1.5 million, respectively.

The Board of Directors has authorized the Company to borrow up to \$20.0 million from various banks and trust companies. As of December 31, 1997, Chesapeake had four unsecured bank lines of credit, totaling \$34.0 million, for short-term cash needs to meet seasonal working capital requirements and to temporarily fund portions of its capital expenditures. The outstanding balances of short-term borrowing at December 31, 1997 and 1996 were \$7.6 million and \$12.7 million, respectively.

In 1997, Chesapeake used cash provided by operations and the issuance of long-term debt to fund capital expenditures and reduce short-term borrowing. During 1996, the Company used cash provided by operating activities and short-term borrowing to fund the capital expenditures and increases in working capital requirements.

During 1997, 1996 and 1995, capital expenditures were approximately \$12.8 million, \$14.8 million and \$12.9 million, respectively. Chesapeake has budgeted \$15.6 million for capital expenditures during 1998. This amount includes \$8.7 million and \$2.7 million for natural gas and propane distribution, respectively; \$3.1 million for natural gas transmission, \$395,000 for advanced information services and \$632,000 for general plant. The natural gas and propane distribution expenditures are for expansion and improvement of facilities in existing service territories. Natural gas transmission expenditures are for improvement and expansion of the pipeline system. The advanced information services expenditures are for computer hardware, software and related equipment. Financing for the 1998 construction program is expected to be provided from short-term borrowing and cash from operations. The construction program is subject to continuous review and modification. Actual construction expenditures may vary from the above estimates due to a number of factors including inflation, changing economic conditions, regulation, sales growth and the cost and availability of capital.

Chesapeake has budgeted \$2.8 million for environmental related expenditures during 1998 and expects to incur additional expenditures in future years (see Note J to the Consolidated Financial Statements), a portion of which may need to be financed through external sources. Management does not expect such financing to have a material adverse effect on the financial position or capital resources of the Company.

### **Capital Structure**

As of December 31, 1997, common equity represented 56.8% of permanent capitalization compared to 62.1% in 1996 and 57.4% in 1995. 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, helps to ensure that Chesapeake will be able to attract capital from outside sources at a reasonable cost. The achievement of these objectives will provide benefits to customers and creditors, as well as to the Company's investors.

### **Financing Activities**

In December 1997, Chesapeake finalized a private placement of \$10 million of 6.85% Senior Notes due January 1, 2012. The Company used the proceeds to repay a portion of its short-term borrowing. In October 1995, the Company finalized a private placement of \$10 million of 6.91% Senior Notes due in 2010. The Company used the proceeds to retire \$4.1

million of the 10.85% Senior Notes of Eastern Shore Natural Gas Company, the Company's natural gas transmission subsidiary ("Eastern Shore") originally due in 2003. The remaining proceeds were used to reduce short-term borrowing. The Company issued no long-term debt in 1996. During 1997, the Company repaid approximately \$3.1 million of long-term debt, compared to \$823,000 and \$5.4 million in 1996 and 1995, respectively. The increase in debt payments for 1997 resulted from the payoff of \$2.2 million of debt assumed in the pooling of interests with Tri-County Gas Company, Inc. ("Tri-County").

On March 6, 1997, the Company acquired all of the outstanding common stock of Tri-County and associated properties. Tri-County distributes propane to both retail and wholesale customers on the peninsula. The transaction was effected through the exchange of 639,000 shares of the Company's common stock and was accounted for as a pooling of interests.

Chesapeake issued 32,169, 33,926 and 38,660 shares of common stock in connection with its Automatic Dividend Reinvestment and Stock Purchase Plan during the years of 1997, 1996 and 1995, respectively.

### Results of Operations

Net income for 1997 was \$5,682,946 as compared to \$7,604,915 for 1996. The decrease in net income is primarily related to temperatures in the Company's northern service territory, which were, on average, 6% warmer than in 1996. The warmer weather resulted in a reduction in volumes sold by the natural gas and propane distribution segments. The lower gas volumes contributed to the reduction in Earnings Before Interest and Taxes ("EBIT") for both distribution segments as shown in the table below.

### EARNINGS BEFORE INTEREST AND TAXES (in thousands):

For the Years Ended December 31,	1997	1996	Increase / (decrease)	1996	1995	Increase / (decrease)
EBIT by Business Segment:						
Natural gas distribution	\$5,498	\$7,167	(\$1,669)	\$7,167	\$4,728	\$2,439
Natural gas transmission	3,721	2,458	1,263	2,458	6,083	(3,625)
Propane distribution	1,064	2,815	(1,751)	2,815	2,252	563
Advanced information services	1,046	1,056	(10)	1,056	1,061	(5)
Other	558	561	(3)	561	(32)	593
Total EBIT	\$11,887	\$14,057	(\$2,170)	\$14,057	\$14,092	(\$35)

Chesapeake's 1996 net income was \$7,604,915, as compared to \$7,593,506 for 1995. Although net income was relatively unchanged, the contribution to net income from each business segment differed during the two-year period. Natural gas distribution EBIT was higher in 1996 due to rate increases placed in effect in two of the three service territories during 1995. EBIT for the propane distribution segment increased due to greater volumes sold due to temperatures being 3% colder than in 1995. Natural gas transmission's contribution decreased due to a reduction in volumes sold to industrial interruptible customers during 1996. In addition, 1995 net income includes a one-time benefit from a settlement with the Federal Energy Regulatory Commission (see Note K to the Consolidated Financial Statements).

### Natural Gas Distribution

The reduction in EBIT of \$1.7 million from 1996 to 1997 is primarily related to a decline in total gross margin, as indicated in the following table, coupled with an overall increase in expenses. The reduction in gross margin earned on volumes sold is primarily the result of a 3% decline in volumes sold to residential and commercial customers and a decrease in volumes sold to industrial interruptible customers in Chesapeake's Florida service territory. The reduction in volumes sold to residential and commercial customers was directly related to warmer temperatures, primarily during

the first quarter of 1997. Operations and maintenance expenses increased \$633,000 and \$108,000, respectively. Compensation, regulatory commission expenses and costs related to data processing and billable service revenue contributed to the increase in operations expenses. A greater level of maintenance to the gas pipeline system resulted in an increase in maintenance expenses.

The \$2.4 million rise in EBIT from 1995 to 1996 resulted from an increase in gross margin earned on sales of natural gas in two of Chesapeake's three service territories, offset by an overall increase in expenses. The \$4.0 million increase in gross margin was partially due to a full year of rate increases, which went into effect in 1995. Maryland operations' rates became effective during December and interim rates were in effect during June of 1995 for Delaware operations. In addition, colder temperatures contributed to the 20% increase in deliveries to residential and commercial customers located in Chesapeake's northern service territory. The \$583,000 increase in operations expenses was primarily the result of higher compensation, benefits, data processing costs, bad debts and regulatory expenses. Plant additions placed in service during 1996 resulted in higher depreciation expense. In addition, other taxes increased by \$460,000 or 23%, partially due to the inclusion of certain state revenue related taxes, which were previously included as reductions to revenue.

#### **GROSS MARGIN SUMMARY (in thousands)**

<b>For the Years Ended December 31,</b>	<b>1997</b>	<b>1996</b>	<b>Increase / (decrease)</b>	<b>1996</b>	<b>1995</b>	<b>Increase / (decrease)</b>
Revenues:						
Gas sold	\$54,205	\$52,290	\$1,915	\$52,290	\$42,784	\$9,506
Gas transported	3,061	2,991	70	2,991	2,618	373
Gas marketed	18,419	19,382	(963)	19,382	8,555	10,827
Other	275	193	82	193	168	25
<b>Total Revenues</b>	<b>\$75,960</b>	<b>\$74,856</b>	<b>\$1,104</b>	<b>\$74,856</b>	<b>\$54,125</b>	<b>\$20,731</b>
Cost of Sales: *						
Gas sold	\$35,507	\$32,846	\$2,661	\$32,846	\$26,789	\$6,057
Gas marketed	18,233	19,117	(884)	19,117	8,410	10,707
<b>Total Cost of Sales</b>	<b>\$53,740</b>	<b>\$51,963</b>	<b>\$1,777</b>	<b>\$51,963</b>	<b>\$35,199</b>	<b>\$16,764</b>
Gross Margin:						
Gas sold	\$18,698	\$19,444	(\$746)	\$19,444	\$15,995	\$3,449
Gas transported	3,061	2,991	70	2,991	2,618	373
Gas marketed	186	265	(79)	265	145	120
Other	275	193	82	193	168	25
<b>Total Gross Margin</b>	<b>\$22,220</b>	<b>\$22,893</b>	<b>(\$673)</b>	<b>\$22,893</b>	<b>\$18,926</b>	<b>\$3,967</b>

\* Transportation service does not have an associated cost of sales.

#### **Natural Gas Transmission**

The Company's natural gas transmission segment, Eastern Shore, which became an open access pipeline on November 1, 1997, had an increase in EBIT of \$1.3 million for 1997. The rise in EBIT is partially attributable to a rate increase and an increase in firm services implemented in 1997, as well as an overall reduction in expenses. The rate increase is designed to generate additional gross margin of approximately \$1.2 million annually. Also contributing to the increase in EBIT were additional revenues generated by the increase in transportation services that were effective with the implementation of open access. On an annual basis, the additional services will generate revenue of approximately \$1.3 million. Operations expense decreased by \$143,000 or 5%, primarily consisting of compensation, relocation costs and property insurance. Maintenance expenses were also lower due to reduced maintenance required during the year on the gas pipeline system. Capital additions during the year resulted in higher depreciation expense.

The \$3.6 million reduction in 1996 EBIT was primarily due to lower gross margin on sales to industrial customers. The gross margin decreased due to a 67% reduction in volumes delivered, primarily reflecting lower deliveries to two industrial interruptible customers — a municipal power plant and a methanol plant. The methanol plant shut down operations on April 1, 1996. During 1996 and 1995, deliveries to the methanol and power plants contributed approximately \$284,000 and \$2.4 million, respectively to gross margin. As interruptible customers, they had no ongoing commitment, contractual or otherwise, to purchase natural gas from the Company (see Note A to the Consolidated Financial Statements). The \$109,000 increase in operating expenses reflects increased compensation and benefit related expenses. Depreciation increased due to plant placed in service.

With Eastern Shore's conversion to open access, all of its customers will have the opportunity to transport gas over its system at rates regulated by the FERC. The variability in Eastern Shore's margins, historically driven by the sales to industrial customers, will dramatically decrease, as capacity reservation fees for transportation services will drive prospective margins. It is expected that in the future, Eastern Shore's EBIT will tend to be more stable and resemble a fully regulated return. Taking the 1997 rate increase, revenues associated with additional capacity and lower margins on services provided to industrial customers into account, the Company expects gross margin during 1998 to be between \$7.9 and \$8.2 million (see Cautionary Statement). Comparatively, gross margin for the past three years has been \$7.9 million, \$6.7 million and \$10.2 million for 1997, 1996 and 1995, respectively.

### ***Propane Distribution***

In 1997, Chesapeake integrated the operations of Tri-County and the Company's existing propane distribution operations. Like Chesapeake's existing propane operations, Tri-County's earnings are heavily dependent upon weather conditions.

The reduction in 1997 EBIT of \$1.8 million was primarily due to a reduction in gross margin, partially offset by a reduction in expenses. Gross margin decreased due to an 11% reduction in sales volumes coupled with a 13% lower margin per gallon sold. The decline in sales volumes is directly related to the warmer temperatures, which averaged 6% warmer than the prior year. Furthermore, during the first quarter of 1997 temperatures were 14% warmer than normal. The Company normally sells a high percentage of its annual volume during this period. The reduction in margin per gallon sold was also the result of abnormally warmer temperatures. As temperatures warmed during the first quarter, demand decreased and supply-prices declined rapidly. Due to the low cost of wholesale-supply, retail prices declined, thereby reducing margins. Operations expenses decreased \$554,000 or 7% primarily in the areas of compensation, delivery related costs, advertising and legal fees. Maintenance expenses declined primarily in equipment and structures. Depreciation and amortization expenses declined \$477,000 or 28% primarily the result of a non-compete agreement, which became fully amortized in November of 1996.

The increase in 1996 EBIT of \$563,000 is primarily attributable to a rise in gross margin partially offset by higher expenses. Gross margin was higher due to a 12% increase in volumes sold and a slight increase in margin earned per gallon sold. The increases are directly related to temperatures which were 3% colder than those in 1995. Operating expenses increased \$1.3 million or 19% in 1996 primarily due to compensation, delivery related costs, benefits and outside services. Maintenance expenses increased in the areas of propane storage facilities, equipment and structures.

### ***Advanced Information Services***

The results of the advanced information services segment consisted primarily of those of United Systems, Inc. ("USI"), due to the downsizing of Chesapeake's North Carolina operations in early 1997. Although the EBIT contribution of this segment has remained unchanged from 1996 to 1997, USI's gross margin has increased by \$970,000 or 34%. Operating expenses increased due to the opening of a new office in Detroit, Michigan and the expansion of staff training and marketing efforts to position USI to be able to provide new services and for future growth of current services. Since the rise in operating costs offset most of the growth in gross margin, EBIT remained constant.

Although the EBIT contributed by the advanced information segment was relatively unchanged from 1995 to 1996, EBIT contributed by USI increased \$268,000. This was mostly offset by a reduction in EBIT contributed by the North Carolina operation as they ceased to provide facilities management services beginning in early 1996.

### **Income Taxes**

Operating income taxes in 1997 decreased \$619,000 due to a reduction in EBIT. This was partially offset by the one-time expense of \$318,000 recorded in 1997 to establish the deferred income tax liability for Tri-County. Prior to 1997, Tri-County was a subchapter S Corporation for income tax reporting; therefore, no deferred income taxes were recorded on its balance sheet. In addition, the Company's 1996 and 1995 restated financial statements do not include any income tax expense for Tri-County due to its subchapter S status during those years.

### **Other**

Non-operating income was \$428,000, \$458,000 and \$391,000 for 1997, 1996 and 1995, respectively. The decrease in 1997 is primarily due to a reduction in interest income, partially offset by the gain on the sale of fixed assets. The increase in 1996 is primarily the result of a rise in interest income earned partially offset by a reduction in the gain on sales of fixed assets.

### **Environmental Matters**

The Company continues to work with federal and state environmental agencies to assess the environmental impact and explore corrective action at several former gas manufacturing plant sites (see Note J to the Consolidated Financial Statements). The Company believes that any future costs associated with these sites will be recoverable in rates.

### **The Year 2000**

Chesapeake is dependent upon information systems to operate efficiently and effectively. In order to address the impact of the year 2000 on its many information systems, Chesapeake is in the process of evaluating and remediating any deficiencies. The Company has segregated the evaluation of its readiness and the potential impact of the year 2000 on its systems into two components: primary internal applications and other applications. The Company's primary applications include systems for its financial information; natural gas customer information and billing; and propane customer information, billing and delivery. Other applications include systems for services such as telephone, system control and data acquisition for the pipeline, as well as other vendors' systems. With respect to the three primary applications, Chesapeake has updated its propane customer information, billing and delivery system to a year 2000 compliant version. This system will be tested further to insure compliance during 1998. With respect to the other two primary applications, Chesapeake has conducted initial evaluations and estimates that the cost of any remediation will not be significant. Each application will be tested during 1998. Chesapeake has developed an inventory of other applications and is in the process of developing plans to contact its vendors, test and remediate to the extent necessary.

### **Competition**

Historically, the Company's natural gas operations have successfully competed with other forms of energy such as electricity, oil and propane. The principle considerations have been price, and to a lesser extent, accessibility. As a result of Eastern Shore's recent conversion to open access, the Company expects to be subject to competitive pressures from other sellers of natural gas. With open access transportation services available on Eastern Shore's system, third party suppliers will compete with Chesapeake to sell gas to the local distribution companies and the end users on Eastern Shore's system. Eastern Shore has shifted from providing sales service to providing transportation and contract storage services.

The Company's distribution operations located in Delaware began to offer transportation services to certain industrial customers in December 1997. Chesapeake expects that during 1998, the distribution operations located in Maryland will also begin offering transportation services. The Company expects to expand the availability of transportation services to additional customers in the future. Since the Florida distribution operations have been open to certain industrial

customers since 1994, the Company has gained experience in operating in an open access environment. The Company established a natural gas brokering and supplies operation in Florida to compete for these customers. The Company is evaluating whether to establish similar services in our northern service territory.

Both the propane distribution and the advanced information services businesses face significant competition from a number of larger competitors with substantially greater resources available to them than those of the Company. In addition, in the advanced information services business, changes are occurring rapidly, which could adversely affect the markets for the Company's services.

### **Inflation**

Inflation affects the cost of labor and other goods and services required for operation, maintenance and capital improvements. The impact of inflation has lessened in recent years, except for the effect on purchased gas costs. These costs are passed on to customers through the purchased gas adjustment clause 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 regulated operations while monitoring the returns of its unregulated business operations.

### **Cautionary Statement**

Statements made herein and elsewhere in this Form 10-K, which are not historical fact, are forward-looking statements. In connection with the "Safe Harbor" provisions of the Private Securities Litigation Reform Act of 1995, Chesapeake is providing the following cautionary statement to identify important factors that could cause actual results to differ materially from those anticipated in forward-looking statements made herein or otherwise by or on behalf of the Company.

A number of factors and uncertainties make it difficult to predict the effect on future operating results of Eastern Shore operating as an open access pipeline, relative to historical results. While open access eliminates industrial interruptible sales margins, such sales have varied widely from year to year and, in future years, might have made a less significant contribution to earnings even in the absence of open access. Additionally, there are a number of uncertainties, including future open access proceedings and the effects of competition, which will affect whether the Company will be able to provide economical gas marketing, transportation and other services.

In addition, a number of factors and uncertainties affecting other aspects of the Company's business could have a material impact on earnings. These include: the seasonality and temperature sensitivity of Chesapeake's natural gas and propane businesses, the relative price of alternative energy sources and the effects of competition on both unregulated and natural gas sales, now that the Company operates in an open access environment. There are also uncertainties relative to the impact of the year 2000 on the information systems of the Company, its vendors and other third parties.

## **Item 8. Financial Statements and Supplemental Data**

### **REPORT OF INDEPENDENT ACCOUNTANTS**

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To the Stockholders of  
Chesapeake Utilities Corporation

We have audited the consolidated financial statements and consolidated financial statement schedules of Chesapeake Utilities Corporation and Subsidiaries listed in Item 14(a) of this Form 10-K. These financial statements and financial statement schedules are the responsibility of the Company's Management. Our responsibility is to express an opinion on these financial statements and the financial statement schedules based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. 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. 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Chesapeake Utilities Corporation and Subsidiaries as of December 31, 1997 and 1996, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 1997 in conformity with generally accepted accounting principles. In addition, in our opinion, the consolidated financial statement schedules referred to above, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information required to be included therein.

We have also previously audited, in accordance with generally accepted standards, the consolidated balance sheets and statements of capitalization as of December 31, 1995, 1994 and 1993, and the related consolidated statements of income, cash flows, stockholders' equity, and income taxes for each of the two years in the period ended December 31, 1994 (none of which are presented herein) and we expressed unqualified opinions on those consolidated financial statements. In our opinion, the information set forth in the Financial Highlights included in the Selected Financial Data for each of the five years in the period ended December 31, 1997, appearing on page 16 is fairly stated in all material respects in relation to the financial statements from which it has been derived.

COOPERS & LYBRAND L.L.P.

Baltimore, Maryland  
February 12, 1998



## CONSOLIDATED BALANCE SHEETS

### Assets

At December 31,	1997	1996
<b><i>Property, Plant and Equipment</i></b>		
Natural gas distribution	\$74,769,458	\$69,853,054
Natural gas transmission	33,856,873	30,655,492
Propane distribution	26,920,403	25,279,217
Advanced information services	841,757	1,003,850
Other plant	6,161,631	5,414,249
Gas plant acquisition adjustment	795,004	795,004
Total property, plant and equipment	143,345,126	133,000,866
Less: Accumulated depreciation and amortization	(43,827,961)	(39,430,738)
Net property, plant and equipment	99,517,165	93,570,128
<b><i>Investments</i></b>	2,721,443	2,263,068
<b><i>Current Assets</i></b>		
Cash and cash equivalents	555,198	2,213,529
Accounts receivable (less allowance for uncollectibles of \$331,775 and \$392,412 in 1997 and 1996, respectively)	13,087,999	14,488,944
Materials and supplies, at average cost	1,380,120	1,284,876
Propane inventory, at average cost	2,288,516	2,345,531
Storage gas prepayments	2,926,618	3,731,680
Underrecovered purchased gas costs	1,673,389	2,192,170
Income taxes receivable	849,623	112,942
Prepaid expenses	1,060,911	942,359
Deferred income taxes	247,487	158,010
Total current assets	24,069,861	27,470,041
<b><i>Deferred Charges and Other Assets</i></b>		
Environmental regulatory assets	4,865,073	6,650,088
Environmental expenditures, net	2,372,929	1,778,348
Other deferred charges and intangible assets	3,832,389	4,314,235
Total deferred charges and other assets	11,070,391	12,742,671
<b><i>Total Assets</i></b>	<b>\$137,378,860</b>	<b>\$136,045,908</b>

See accompanying notes

## Capitalization and Liabilities

At December 31,	1997	1996
<b>Capitalization</b>		
Stockholders' equity		
Common stock	\$2,191,792	\$2,160,628
Additional paid-in capital	19,819,604	18,745,718
Retained earnings	28,218,763	26,957,048
Less: Unearned compensation related to restricted stock awarded	(190,886)	(364,529)
Unrealized gain on marketable securities, net	296,872	38,598
Total stockholders' equity	50,336,145	47,537,463
Long-term debt, net of current portion	38,226,000	28,984,368
Total capitalization	88,562,145	76,521,831
<b>Current Liabilities</b>		
Current portion of long-term debt	582,500	3,078,489
Short-term borrowings	7,600,000	12,700,000
Accounts payable	12,451,570	14,426,983
Refunds payable to customers	357,041	353,734
Accrued interest	784,533	741,768
Dividends payable	1,092,168	883,621
Other accrued expenses	3,807,484	3,733,233
Total current liabilities	26,675,296	35,917,828
<b>Deferred Credits and Other Liabilities</b>		
Deferred income taxes	11,490,358	9,798,676
Deferred investment tax credits	821,617	876,432
Environmental liability	4,865,073	6,650,088
Accrued pension costs	1,754,715	1,866,661
Other liabilities	3,209,656	4,414,392
Total deferred credits and other liabilities	22,141,419	23,606,249
<b>Commitments and Contingencies</b>		
<i>(Notes J and K)</i>		
<b>Total Capitalization and Liabilities</b>	<b>\$137,378,860</b>	<b>\$136,045,908</b>

See accompanying notes

## CONSOLIDATED STATEMENTS OF INCOME

For the Years Ended December 31,	1997	1996	1995
<b>Operating Revenues</b>	\$122,774,593	\$130,213,409	\$111,795,778
<b>Cost of Sales</b>	77,764,830	82,226,644	65,616,368
<b>Gross Margin</b>	45,009,763	47,986,765	46,179,410
<b>Operating Expenses</b>			
Operations	21,831,194	22,230,425	20,612,585
Maintenance	2,041,043	2,504,894	2,477,454
Depreciation and amortization	5,396,975	5,504,637	5,802,884
Other taxes	3,853,954	3,689,748	3,194,673
Income taxes	3,327,627	3,947,056	4,025,274
Total operating expenses	36,450,793	37,876,760	36,112,870
<b>Operating Income</b>	8,558,970	10,110,005	10,066,540
<b>Other Income</b>			
Interest income	239,543	249,509	191,845
Other income, net	405,156	177,045	239,687
Income taxes	(216,988)	(83,739)	(105,280)
Allowance for equity funds used during construction		115,434	65,198
Total other income	427,711	458,249	391,450
<b>Income Before Interest Charges</b>	8,986,681	10,568,254	10,457,990
<b>Interest Charges</b>			
Interest on long-term debt	2,347,369	2,392,458	2,282,247
Amortization of debt expense	119,401	120,345	109,399
Other	922,110	514,856	566,320
Allowance for borrowed funds used during construction	(85,145)	(64,320)	(93,482)
Total interest charges	3,303,735	2,963,339	2,864,484
<b>Net Income</b>	\$5,682,946	\$7,604,915	\$7,593,506
<b>Earnings Per Share of Common Stock :</b>			
Basic:	\$1.27	\$1.72	\$1.75
Diluted:	\$1.24	\$1.67	\$1.70

*See accompanying notes*

## CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31,	1997	1996	1995
<b>Operating Activities</b>			
Net Income	\$5,682,946	\$7,604,915	\$7,593,506
Adjustments to reconcile net income to net operating cash:			
Depreciation and amortization	6,090,665	6,148,232	6,246,222
Allowance for equity funds used during construction		(115,434)	(65,198)
Investment tax credit adjustments	(54,815)	(54,815)	(54,815)
Deferred income taxes, net	1,437,206	1,794,146	252,727
Employee benefits	(238,826)	471,870	178,803
Employee compensation from lapsing of stock restrictions	173,643	334,745	431,694
Allowance for refund			(1,356,705)
Other, net	(286,147)	83,301	(339,081)
Changes in assets and liabilities:			
Accounts receivable, net	1,400,945	(904,516)	(4,727,364)
Other current assets	648,282	(2,141,048)	1,588,675
Other deferred charges	(625,395)	(977,652)	(946,450)
Accounts payable, net	(1,823,912)	1,422,807	3,619,023
Refunds payable to customers	3,307	(613,206)	400,192
Overrecovered (underrecovered) purchased gas costs	518,781	(2,245,544)	162,399
Other current liabilities	(619,668)	396,326	939,750
Net cash provided by operating activities	12,307,012	11,204,127	13,923,378
<b>Investing Activities</b>			
Property, plant and equipment expenditures, net	(12,380,826)	(14,069,116)	(11,666,442)
Allowance for equity funds used during construction		115,434	65,198
Purchases of investments	(36,167)	(129,406)	(38,836)
Net cash used by investing activities	(12,416,993)	(14,083,088)	(11,640,080)
<b>Financing Activities</b>			
Common stock dividends, net of amounts reinvested of \$382,932, \$346,308 and \$304,106 in 1997, 1996 and 1995, respectively	(3,829,752)	(3,337,755)	(3,324,376)
Issuance of stock -- Dividend Reinvestment Plan optional cash	167,337	208,813	202,835
Issuance of stock -- Retirement Savings Plan	404,297	349,031	
Net (repayments) borrowings under line of credit agreements	(5,100,000)	7,300,000	(3,197,039)
Proceeds from issuance of long-term debt	9,908,223		10,428,753
Repayment of long-term debt	(3,098,455)	(823,213)	(5,439,151)
Net cash (used) provided by financing activities	(1,548,350)	3,696,876	(1,328,978)
<b>Net (Decrease) Increase in Cash and Cash Equivalents</b>	(1,658,331)	817,915	954,320
<b>Cash and Cash Equivalents at Beginning of Year</b>	2,213,529	1,395,614	441,294
<b>Cash and Cash Equivalents at End of Year</b>	\$555,198	\$2,213,529	\$1,395,614
<b>Supplemental Disclosure of Cash Flow Information</b>			
Cash paid for interest	\$3,203,709	\$2,831,109	\$2,884,864
Cash paid for income tax	\$3,400,479	\$2,122,120	\$3,288,895

See accompanying notes

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

For the Years Ended December 31,	1997	1996	1995
<b>Common Stock</b>			
Balance -- beginning of year	\$2,160,628	\$2,122,212	\$2,096,515 <sup>(1)</sup>
Dividend Reinvestment Plan	15,398	16,514	18,816
USI restricted stock award agreements		10,639	6,881
Conversion of debentures	4,461	429	
Company's Retirement Savings Plan	11,305	9,928	
Exercised stock options		906	
Balance -- end of year	2,191,792	2,160,628	2,122,212
<b>Additional Paid-in Capital</b>			
Balance -- beginning of year	18,745,718	17,489,108	16,731,689 <sup>(1)</sup>
Dividend Reinvestment Plan	529,453	538,607	488,125
USI restricted stock award agreements		344,570	176,029
Sale of treasury stock to Company's Retirement Savings Plan			93,265
Conversion of debentures	151,441	14,557	
Company's Retirement Savings Plan	392,992	328,465	
Exercised stock options		30,411	
Balance -- end of year	19,819,604	18,745,718	17,489,108
<b>Retained Earnings</b>			
Balance -- beginning of year	26,957,048	23,458,776	19,480,374
Net income	5,682,946	7,604,915	7,593,506 <sup>(1)</sup>
Cash dividends -- Chesapeake <sup>(2)</sup>	(4,341,964)	(3,514,694)	(3,331,972)
Cash dividends -- Pooled companies	(79,267)	(591,949)	(283,132)
Balance -- end of year	28,218,763	26,957,048	23,458,776
<b>Treasury Stock <sup>(3)</sup></b>			
<b>Unearned Compensation</b>			
Balance -- beginning of year	(364,529)	(415,107)	(696,679)
Issuance of award		(284,167)	(121,343)
Amortization of prior years' awards	173,643	334,745	402,915
Balance -- end of year	(190,886)	(364,529)	(415,107)
<b>Unrealized Gain (Loss) on Marketable Securities <sup>(4)</sup></b>	296,872	38,598	(72,839)
<b>Total Stockholders' Equity</b>	<b>\$50,336,145</b>	<b>\$47,537,463</b>	<b>\$42,582,150</b>

<sup>(1)</sup> The following adjustments have been made to 1995 presentation to reflect the Tri-County pooling of interests: Beginning balances of Common Stock and Additional Paid-in Capital have been adjusted by \$311,001 and (\$103,314), respectively. Net income as shown in the Retained Earnings section has been adjusted by \$356,811.

<sup>(2)</sup> Dividends per share of common stock were \$.97, \$.93 and \$.90 for the years 1997, 1996 and 1995, respectively.

<sup>(3)</sup> The entire Treasury Stock balance of (\$99,842) was sold to the Company's Retirement Savings Plan during 1995, leaving a zero balance.

<sup>(4)</sup> Net of income tax expense (benefit) of approximately \$190,000, \$25,000 and (\$48,000) for the years 1997, 1996 and 1995, respectively.

See accompanying notes

## CONSOLIDATED STATEMENTS OF INCOME TAXES

For the Years Ended December 31,	1997	1996	1995
<b>Current Income Tax Expense</b>			
Federal	\$1,916,654	\$1,884,609	\$3,182,346
State	442,563	356,576	621,238
Investment tax credit adjustments, net	(54,815)	(54,815)	(54,815)
Total current income tax expense	2,304,402	2,186,370	3,748,769
<b>Deferred Income Tax Expense</b>			
Property, plant and equipment	1,335,802	581,373	455,151
Deferred gas costs	(204,170)	873,904	(56,915)
Pensions and other employee benefits	(19,508)	107,131	57,508
Unbilled revenue	(104,632)	54,320	(260,922)
Contributions in aid of construction	(33,028)	(6,979)	(283,033)
Environmental expenditures	249,417	108,578	272,068
Allowance for refund		121,671	442,064
Other	16,332	4,427	(244,136)
Total deferred income tax expense <sup>(1)</sup>	1,240,213	1,844,425	381,785
Total Income Tax Expense	\$3,544,615	\$4,030,795	\$4,130,554
<b>Reconciliation of Effective Income Tax Rates</b>			
Federal income tax expense at 34%	3,171,505	3,956,118	3,986,180
State income taxes, net of Federal benefit	399,213	537,566	546,955
Acquisition of subchapter S Corporation <sup>(2)</sup>	317,821	(268,211)	(137,800)
Other	(343,924)	(194,678)	(264,781)
Total income tax expense	\$3,544,615	\$4,030,795	\$4,130,554
Effective income tax rate	38.4%	36.8%	36.3%

For the Years Ended December 31,	1997	1996
<b>Deferred Income Taxes</b>		
Deferred income tax liabilities:		
Property, plant and equipment	\$12,095,782	\$10,716,757
Deferred gas costs	649,681	853,851
Other	1,560,988	1,322,272
Total deferred income tax liabilities	14,306,451	12,892,880
Deferred income tax assets:		
State operating loss carryforwards	57,303	3,320
Deferred investment tax credit	403,789	426,565
Unbilled revenue	968,311	863,679
Pension and other employee benefits	898,060	917,568
Self insurance	585,995	545,836
Other	150,122	495,246
Total deferred income tax assets	3,063,580	3,252,214
Deferred Income Taxes Per Consolidated Balance Sheet	\$11,242,871	\$9,640,666

<sup>(1)</sup> Includes \$208,000, \$392,000 and \$108,000 of deferred state income taxes for the years 1997, 1996 and 1995, respectively.

<sup>(2)</sup> Accounted for as a pooling of interests (see Note B to the Consolidated Financial Statements).

See accompanying notes

## **A. Summary of Accounting Policies**

### **Nature of Business**

Chesapeake Utilities Corporation (the "Company") is engaged in natural gas distribution to approximately 35,800 customers located in southern Delaware, Maryland's Eastern Shore and Central Florida. The Company's natural gas transmission subsidiary operates a pipeline from various points in Pennsylvania to the Company's Delaware and Maryland distribution divisions, as well as other utility and industrial customers in Delaware and the Eastern Shore of Maryland. The Company's propane distribution segment serves approximately 34,000 customers in southern Delaware, the Eastern Shore of Maryland and Virginia. The advanced information services segment provides software services and products to a wide variety of clients.

### **Principles of Consolidation**

The Consolidated Financial Statements include the accounts of the Company and its wholly owned subsidiaries, Eastern Shore Natural Gas Company ("Eastern Shore"), Sharp Energy, Inc. ("Sharp Energy"), Tri-County Gas Company, Inc. ("Tri-County") and Chesapeake Service Company. Sharp Energy's accounts include those of its wholly owned subsidiary, Sharpgas, Inc. Chesapeake Service Company's accounts include United Systems, Inc. ("USI"), Capital Data Systems, Inc. and Skipjack, Inc. Investments in entities in which the Company owns more than 20 percent but 50 percent or less, are accounted for by the equity method. All significant 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 the Delaware, Maryland and Florida Public Service Commissions with respect to their rates for service, maintenance of their accounting records and various other matters. Eastern Shore is subject to regulation by the Federal Energy Regulatory Commission ("FERC"). The Company's financial statements are prepared on the basis of generally accepted accounting principles which give appropriate recognition to the ratemaking and accounting practices and policies of the various commissions. The propane and advanced information services subsidiaries are not subject to regulation with respect to rates or maintenance of accounting records.

### **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. Investments with an original maturity of three months or less are considered cash equivalents.

### **Property, Plant, Equipment and Depreciation**

Utility property is stated at original cost while the assets of the propane subsidiary are valued at cost. The costs of repairs and minor replacements are charged to income as incurred and the costs of major renewals and betterments are capitalized. Upon retirement or disposition of utility property, the recorded cost of removal, net of salvage value, is charged to accumulated depreciation. Upon retirement or disposition of non-utility property, the gain or loss, net of salvage value, is charged to income. The provision for depreciation is computed using the straight-line method at rates, which will amortize the unrecovered cost of depreciable property over the estimated useful life. Depreciation and amortization expense for financial statement purposes is provided at an annual rate for each segment averaging 4.73% for natural gas distribution; 3.04% for natural gas transmission and 5.46% for propane distribution. In addition, the annualized rates average 4.73% for gas plant acquisition adjustments, 17.78% for the advanced information services segment and 2.59% for general plant.

### **Allowance for Funds Used During Construction**

The allowance for funds used during construction ("AFUDC") is an accounting procedure whereby the cost of borrowed funds and other funds used to finance construction projects is capitalized as part of utility plant on the balance sheet, crediting the cost as a non-cash item on the income statement. The costs of borrowed and equity funds are segregated

between interest expense and other income, respectively. AFUDC was capitalized on utility plant construction at the rates of 5.63%, 9.51% and 7.31% for 1997, 1996 and 1995, respectively.

### **Environmental Regulatory Assets**

Environmental regulatory assets represent amounts related to environmental liabilities for which cash expenditures have not been made. As expenditures are incurred, the environmental liability can be reduced along with the environmental regulatory asset. These amounts are recorded to either environmental expenditures or accumulated depreciation as cost of removal. All amounts incurred are amortized in accordance with the ratemaking treatment granted in each jurisdiction.

### **Other Deferred Charges and Intangible Assets**

Other deferred charges include discount, premium and issuance costs associated with long-term debt and rate case expenses. The discount, premium and issuance costs are deferred, then amortized over the original lives of the respective debt issues. Gains and losses on the reacquisition of debt are amortized over the remaining lives of the original issuance(s). Rate case expenses are deferred, then amortized over periods approved by the applicable regulatory authorities. Intangible assets are associated with the acquisition of non-utility companies, and are amortized on a straight-line basis over a period of five to 40 years. The gross intangible assets were \$2,516,120 and \$1,920,851 at December 31, 1997 and 1996, respectively. Accumulated amortization related to intangible assets was \$1,093,905 and \$962,227 at December 31, 1997 and 1996, respectively. In addition, the 1997 acquisition of a propane business resulted in the Company acquiring goodwill, a customer list and a non-compete agreement valued at \$437,000, \$108,000 and \$50,000, respectively.

### **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 and tax bases of assets and liabilities, and are measured using current effective income tax rates. The portion of the Company's deferred tax liabilities applicable to utility operations which has not been reflected in current service rates represents income taxes recoverable through future rates. Investment tax credits on utility property have been deferred and are allocated to income ratably over the lives of the subject property.

The Company had state tax loss carryforwards of \$796,000 and \$46,000 at December 31, 1997 and 1996, respectively. The Company expects to use all of the loss carryforwards; therefore, no valuation allowance was recorded at December 31, 1997 or 1996. The loss carryforwards expire in 2006 through 2012.

### **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 C to the Consolidated Financial Statements for disclosure of fair value of investments). The fair value of the Company's long-term debt is estimated using a discounted cash flow methodology. The estimated fair value of the Company's long-term debt at December 31, 1997, including current maturities, is approximately \$40.7 million as compared to a carrying value of \$38.8 million. At December 31, 1996, the estimated fair value was approximately \$30.3 million as compared to a carrying value of \$29.8 million. These estimates are based on published corporate borrowing rates for debt instruments with similar terms and average maturities.

### **Operating Revenues**

Revenues for the natural gas distribution divisions of the Company are based on rates approved by the various commissions. Customers' base rates may not be changed without formal approval by these commissions. With the



exception of the Company's Florida division, the Company recognizes revenues from meters read on a monthly cycle basis. This practice results in unbilled and unrecorded revenue from the cycle date through month-end. The Florida division recognizes revenues based on services rendered and records an amount for gas delivered but not billed. The propane segment recognizes revenue for certain customers on a metered basis and all other customers on an as-delivered basis.

The natural gas distribution divisions of the Company have purchased gas adjustment ("PGA") clauses that provide for the adjustment of rates charged to customers as gas costs fluctuate. These amounts are collected or refunded through adjustments to rates in subsequent periods.

The natural gas transmission segment became an open access pipeline on November 1, 1997 with revenues based on rates approved by FERC. Before open access, only portions of revenues were based on rates approved by FERC. In addition, the transmission segment had a PGA clause similar to those in the distribution operations. Since the transmission segment records revenue for service only, the PGA clause no longer applies, now that open access is in effect.

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

### Earnings Per Share

The Company has adopted Statement of Financial Accounting Standards ("SFAS") No. 128, issued by the Financial Accounting Standards Board ("FASB") in February 1997, requiring dual presentation of basic and diluted per share earnings on the face of the income statement. Basic earnings per share is based on the weighted average number of shares of common stock outstanding. On a diluted basis, both earnings and shares outstanding are adjusted for stock options for each year presented and the assumed conversion of the convertible debentures. The adoption of SFAS No. 128 did not have a material effect on the Company's financial statements. Prior years' presentations of earnings per share have been restated to conform to the guidelines of SFAS No. 128.

### CALCULATION OF DILUTED EARNINGS PER SHARE:

For the Years Ended December 31,	1997	1996	1995
<u>Reconciliation of Numerator:</u>			
Net Income — basic	\$5,682,946	\$7,604,915	\$7,593,506
Effect of 8.25% Convertible debentures	204,070	207,825	213,043
Adjusted numerator — diluted	\$5,887,016	\$7,812,740	\$7,806,549
<u>Reconciliation of Denominator:</u>			
Weighted Shares Outstanding — basic	4,472,087	4,412,137	4,336,431
Effect of Dilutive Securities			
8.25% Convertible debentures	238,353	242,742	248,833
Stock options and performance shares *	38,462	22,053	4,487
Adjusted denominator — diluted	4,748,902	4,676,932	4,589,751
Diluted Earnings per Share	\$1.24	\$1.67	\$1.70

\* The impact of the 95,492 stock options that were granted in 1997 (see Note H to the Consolidated Financial Statements) could potentially dilute earnings per share in the future.

**Certain Risks and Uncertainties**

The financial statements are prepared in conformity with generally accepted accounting principles that require management to make estimates (see Note J to the Consolidated Financial Statements for significant estimates) in measuring assets and liabilities and related revenue and expenses. These estimates involve judgements 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 regulated operations, all such deferred amounts would be recognized in the income statement at that time, resulting in a charge to earnings, net of applicable income taxes.

**FASB Statements Issued**

**Comprehensive Income.** In June 1997, the FASB issued SFAS No. 130 regarding the reporting of comprehensive income in the full set of financial statements. The Company must adopt the requirements of the standard in its financial statements for the year beginning January 1, 1998. The effect of the adoption of the standard pertains primarily to SFAS No. 115 regarding held for sale investments, and is not expected to have a material impact on the Company's financial statements.

**Segment Information.** In June 1997, FASB issued SFAS No. 131, establishing standards for public business enterprises to report information about operating segments in annual financial statements and requiring that those enterprises report selected information about operating segments in interim financial reports to shareholders. The Company will adopt the requirements of this standard in the first quarter of the 1998 fiscal year. The adoption of the standard is not expected to have a material impact on the Company's financial statements.

**Reclassification of Prior Years' Amounts**

Certain prior years' amounts have been reclassified to conform to current year presentation.

## B. Business Combinations

In March 1997, the Company acquired all of the outstanding common stock of Tri-County Gas Company, Inc. and associated properties. Tri-County's principal business is the distribution of propane to both retail and wholesale customers in southern Delaware, the Eastern Shore of Maryland and Virginia. Six hundred thirty-nine thousand shares of the Company's common stock were exchanged in the transaction, which was accounted for as a pooling of interests. All prior period consolidated financial statements presented have been restated to include the combined results of operations, financial position and cash flows of Tri-County. All material transactions between the Company and Tri-County have been eliminated in consolidation. The results of operations for the separate companies and the combined amounts are presented in the consolidated financial statements to follow.

	Two months ended February 28, 1997	Year Ended December 31, 1996	Year Ended December 31, 1995
Operating Revenues			
Chesapeake	\$29,690,819	\$119,330,068	\$104,020,416
Tri-County	2,652,910	10,883,341	7,775,362
Combined	\$32,343,729	\$130,213,409	\$111,795,778
Net Income			
Chesapeake	\$2,434,351	\$6,910,428	\$7,236,695
Tri-County	265,059	694,487	356,811
Combined	\$2,699,410	\$7,604,915	\$7,593,506
Unaudited Pro Forma Net Income *			
Chesapeake	N/A	\$6,910,428	\$7,236,695
Tri-County	N/A	426,276	219,011
Combined	N/A	\$7,336,704	\$7,455,706

\* Unaudited pro forma net income reflects adjustments to net income to record an estimated provision for income taxes, assuming Tri-County was a tax paying entity in 1996 and 1995. During 1997, Tri-County was a C Corporation for federal income tax purposes. Tri-County will be included in the Company's U.S. federal income tax return, effective March 1997.

## C. Investments

The investment balance at December 31, 1997 and 1996 consists primarily of the common stock of Florida Public Utilities Company ("FPU"). The Company's ownership at December 31, 1997 and 1996 represents a 7.34% and 7.41% interest, respectively. The Company has classified its investment in FPU as an "Available for Sale" security, which requires that all unrealized gains and losses be excluded from earnings and be reported net of income tax as a separate component of stockholders' equity. At December 31, 1997 and 1996, the market value exceeded the aggregate cost basis of the Company's portfolio by \$486,872 and \$63,598, respectively.

## D. Lease Obligations

The Company has entered several operating lease arrangements for office space at various locations. Rent expense related to these leases was \$277,000, \$293,000 and \$409,000 for 1997, 1996 and 1995, respectively. Future minimum payments under the Company's current lease agreements are \$236,000; \$228,000; \$232,000; \$145,000 and \$91,000 for the years of 1998 through 2002, respectively; and \$198,000 thereafter.

## E. Segment Information

For the Years Ended December 31,	1997	1996	1995
<b>Operating Revenues, Unaffiliated Customers</b>			
Natural gas distribution	\$75,940,968	\$74,904,100	\$54,120,280
Natural gas transmission	12,164,369	15,188,752	24,984,767
Propane distribution	26,994,404	33,179,114	25,345,696
Advanced information services	7,636,407	6,903,246	7,307,413
Other	38,445	38,197	37,622
Total operating revenues, unaffiliated customers	\$122,774,593	\$130,213,409	\$111,795,778
<b>Intersegment Revenues *</b>			
Natural gas distribution	\$18,970	\$12,232	\$5,095
Natural gas transmission	19,282,359	21,543,352	16,663,043
Propane distribution	52,230	2,059	139,052
Advanced information services	149,602	326,913	1,554,498
Other	523,007	332,512	349,508
Total intersegment revenues	\$20,026,168	\$22,217,068	\$18,711,196
<b>Operating Income Before Income Taxes</b>			
Natural gas distribution	\$5,498,471	\$7,167,237	\$4,728,348
Natural gas transmission	3,721,148	2,458,442	6,083,440
Propane distribution	1,063,554	2,814,958	2,252,165
Advanced information services	1,045,912	1,056,201	1,061,309
Other	524,785	406,632	215,146
Total	11,853,870	13,903,470	14,340,408
Add (Less): Eliminations	32,727	153,591	(248,594)
Total operating income before income taxes	\$11,886,597	\$14,057,061	\$14,091,814
<b>Depreciation and Amortization</b>			
Natural gas distribution	\$3,076,654	\$2,907,831	\$2,468,141
Natural gas transmission	892,258	697,834	638,099
Propane distribution	1,204,968	1,681,588	1,629,971
Advanced information services	122,081	131,877	969,587
Other	101,014	85,507	97,086
Total depreciation and amortization	\$5,396,975	\$5,504,637	\$5,802,884
<b>Capital Expenditures</b>			
Natural gas distribution	\$5,826,065	\$6,472,459	\$7,424,489
Natural gas transmission	3,286,860	5,567,509	1,335,793
Propane distribution	2,820,166	2,189,368	2,427,773
Advanced information services	277,015	162,189	114,461
Other	559,043	445,916	1,584,813
Total capital expenditures	\$12,769,149	\$14,837,441	\$12,887,329
<b>Identifiable Assets, at December 31,</b>			
Natural gas distribution	\$78,732,860	\$77,426,232	\$72,256,841
Natural gas transmission	24,781,292	23,981,989	19,292,524
Propane distribution	24,209,693	25,009,751	22,723,647
Advanced information services	1,751,192	1,496,419	1,635,100
Other	7,903,823	8,131,517	7,430,616
Total identifiable assets	\$137,378,860	\$136,045,908	\$123,338,728

\* All significant intersegment revenues have been eliminated from consolidated revenues.

## F. Long-term Debt

The outstanding long-term debt, net of current maturities, is as follows:

At December 31,	1997	1996
First mortgage sinking fund bonds:		
Adjustable rate Series G*, due January 1, 1998	\$ 0	\$ 62,500
9.37% Series I, due December 15, 2004	4,300,000	4,820,000
12.00% Mortgage, due February 1, 1998		14,868
8.25% Convertible debentures, due March 1, 2014	3,926,000	4,087,000
Uncollateralized Senior notes:		
7.97% note, due February 1, 2008	10,000,000	10,000,000
6.91% note, due October 1, 2010	10,000,000	10,000,000
6.85% note, due January 1, 2012	10,000,000	
Total long-term debt	\$38,226,000	\$28,984,368

\* The Series G bonds are subject to an interest rate equal to seventy-three percent (73%) of the prime rate (8.50% and 8.25% at December 31, 1997 and 1996, respectively).

Annual maturities of consolidated long-term debt for the next five years are as follows: \$582,500 for 1998, \$1,520,000 for 1999 and \$2,665,091 for the years 2000 through 2002.

On December 15, 1997, the Company issued \$10 million of 6.85% senior notes due January 1, 2012. The Company used the proceeds to repay a portion of the Company's short-term borrowing.

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 1997, \$156,000 in debentures were converted. The debentures are redeemable at the option of the holder, subject to an annual non-cumulative maximum limitation of \$200,000 in the aggregate. As of December 31, 1997, no debentures have been accepted for redemption in 1998. At the Company's option, the debentures may be redeemed at the stated amounts.

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% of total capitalization, the times interest earned ratio must be at least 2.5 and the Company cannot, until the retirement of its Series I bonds, pay any dividends after December 31, 1988 which exceed the sum of \$2,135,188 plus consolidated net income recognized on or after January 1, 1989. As of December 31, 1997, the amounts available for future dividends permitted by the Series I covenant approximated \$14.6 million.

A portion of the natural gas distribution plant assets owned by the Company are subject to a lien under the mortgage pursuant to which the Company's first mortgage sinking fund bonds are issued.

## G. Short-term Borrowing

The Board of Directors has authorized the Company to borrow up to \$20.0 million from various bank and trust companies. As of December 31, 1997, the Company had four unsecured bank lines of credit totaling \$34.0 million, none of which required compensating balances. Under these lines of credit at December 31, 1997 and 1996, the Company had short-term debt outstanding of \$7.6 million and \$12.7 million, respectively, with a weighted average interest rate of 5.63% and 6.12%, respectively.

## H. Common Stock, Additional Paid-in Capital and Treasury Stock

The following is a schedule of changes in the Company's shares of common stock.

For the Years Ended December 31,	1997	1996	1995 <sup>(1)</sup>
<b>Common Stock: Shares issued and outstanding <sup>(2)</sup></b>			
Balance – beginning of year	4,439,516	4,360,589	4,307,791
Dividend Reinvestment Plan <sup>(3)</sup>	32,169	33,926	38,660
Sale of stock to Company's Retirement Savings Plan	23,228	20,398	
USI restricted stock award agreements		21,859	14,138
Conversion of debentures	9,166	881	
Exercised stock options		1,863	
Balance – end of year	4,504,079	4,439,516	4,360,589

(1) The 1995 beginning balance of 4,307,791 has been restated to include 639,000 shares of Common Stock that were issued to effect the business combination with Tri-County.

(2) 12,000,000 shares are authorized at a par value of \$.4867 per share.

(3) Includes dividends and reinvested optional cash payments.

At the beginning of 1995, the Company had 15,609 shares of common stock held in treasury. During 1995, all of these were sold to the Company's retirement savings plan.

Certain key USI employees entered into restricted stock award agreements under which shares of Chesapeake common stock can be issued. Shares were awarded as a non-cash transaction over a five-year period beginning in 1992, and restrictions lapse over a five to ten-year period from the award date, if certain financial targets are met. At December 31, 1997 and 1996, respectively, 12,515 and 24,350 shares valued at \$190,886 and \$364,529 remain restricted.

The Performance Incentive Plan, which was adopted in 1992, provides for the granting of stock options to certain officers of the Company over a 10-year period. In November 1994, the Company executed Tandem Stock Option and Performance Share Agreements ("Agreements") with certain executive officers. These Agreements provide the participants an option to purchase shares of the Company's common stock, exercisable in cumulative installments of one-third on each anniversary of the commencement of the award period. The Agreements also enable the participants the right to earn performance shares upon the Company's achievement of the performance goals set forth in the Agreements. During the three-year period ended December 31, 1997, the aforementioned performance goals were achieved. Following the approval of the Board of Directors on February 27, 1998, the Company issued 44,081 performance shares. Forty-four thousand ninety-six stock options expired upon the issuance of the performance shares on February 27. In 1997, the Company recorded \$415,681 to recognize the compensation expense associated with the performance shares. Changes in outstanding options were as follows:

	1997		1996		1995	
	Number of shares	Option Price	Number of shares	Option price	Number of shares	Option Price
Balance – beginning of year	113,051	\$12.625 - \$12.75	125,186	\$12.625 - \$12.75	136,186	\$12.625 - \$12.75
Options granted	95,492	\$20.50				
Options exercised			(12,135)	\$12.75		
Options forfeited					(11,000)	\$12.625
Balance – end of year	208,543	\$12.625 - \$20.50	113,051	\$12.625 - \$12.75	125,186	\$12.625 - \$12.75
Exercisable	98,083	\$12.625 - \$12.75	83,114	\$12.625 - \$12.75	80,280	\$12.75

In December 1997, the Company granted stock options to certain executive officers of the Company. As required by SFAS No. 123, 1997 pro forma net income as if fair value based accounting had been used to account for the stock-based compensation costs is \$5,679,603. Pro forma basic and diluted earnings per share are \$1.27 and \$1.24, respectively. Pro forma disclosures for 1997 are not likely to be representative of future effects of reported net income. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 1997: dividend yield of 4.73%; expected volatility of 15.53%; risk-free interest rate of 5.89%; and expected lives of four years.

## I. Employee Benefit Plans

### Pension Plan

The Company sponsors a defined benefit pension plan covering substantially all of its employees. Benefits under the plan are based on each participant's years of service and highest average compensation. 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.

### Pension Cost

For the Years Ended December 31,	1997	1996	1995
Service cost	\$680,192	\$656,985	\$474,000
Interest cost	732,188	658,238	562,003
Actual return on assets	(2,427,768)	(1,142,287)	(1,546,325)
Net amortization and deferral	1,421,028	269,135	689,947
Total net pension cost	405,640	442,071	179,625
Amounts capitalized as construction cost	(33,942)	(38,860)	(30,740)
Amount charged to expense	\$371,698	\$403,211	\$148,885

The following schedule sets forth the funding status of the pension plan at December 31, 1997 and 1996.

### Accrued Pension Cost

At December 31,	1997	1996
Vested	\$7,615,194	\$6,834,661
Non-vested	123,255	139,483
Total accumulated benefit obligation	\$7,738,449	\$6,974,144
Plan assets at fair value	\$13,592,699	\$10,720,514
Projected benefit obligation	(11,534,355)	(10,265,987)
Plan assets less projected benefit obligation	2,058,344	454,527
Unrecognized net gain	(4,038,679)	(2,820,957)
Unamortized net assets from adoption of SFAS No. 87	(198,326)	(141,579)
Accrued pension cost	(\$2,178,661)	(\$2,508,009)
<b>Assumptions:</b>		
Discount rate	7.25%	7.25%
Average increase in future compensation levels	4.75%	4.75%
Expected long-term rate of return on assets	8.50%	8.50%

### Other Post-retirement Benefits

The Company sponsors a defined benefit post-retirement health care and life insurance plan that covers substantially all natural gas and corporate employees. The Company had deferred approximately \$126,000, which represented the

difference between the Maryland division's SFAS No. 106 expense and its actual pay-as-you-go cost. The amount is being amortized over five years starting in 1995. The unamortized balance is \$78,000 at December 31, 1997.

### Post-retirement Cost

For the Years Ended December 31,	1997	1996	1995
Service cost	\$3,287	\$2,820	\$1,827
Interest cost on APBO	60,221	54,651	59,706
Amortization of transition obligation over 20 years	29,413	27,859	27,859
<b>Net periodic post-retirement benefit cost</b>	<b>92,921</b>	<b>85,330</b>	<b>89,392</b>
Amount capitalized as construction cost	(16,274)	(16,672)	(14,010)
Amount amortized (deferred)	25,254	25,254	(20,561)
<b>Amount charged to expense</b>	<b>\$101,901</b>	<b>\$93,912</b>	<b>\$54,821</b>

### Accrued Post-retirement Liability

At December 31,	1997	1996
<b>Accumulated post-retirement benefit obligation:</b>		
Retirees	\$621,203	\$567,599
Fully eligible active employees	145,356	137,378
Other active	102,340	86,894
Total accumulated post-retirement benefit obligation	868,899	791,871
Unrecognized transition obligation	(245,154)	(273,013)
Unrecognized net (loss) gain	(147,422)	(67,155)
<b>Accrued post-retirement liability</b>	<b>\$476,323</b>	<b>\$451,703</b>
<b>Assumption:</b>		
Discount rate	7.25%	7.25%

The health care inflation rate for 1997 is assumed to be 9.5%. This rate is projected to gradually decrease to an ultimate rate of 5% by the year 2007. A one percentage point increase in the health care inflation rate from the assumed rate would increase the accumulated post-retirement benefit obligation by approximately \$98,650 as of January 1, 1998, and would increase the aggregate of the service cost and interest cost components of net periodic post-retirement benefit cost for 1998 by approximately \$8,293.

### Retirement Savings Plan

The Company sponsors a Retirement Savings Plan, a 401(k) plan ("Plan"), that provides participants a mechanism for making contributions for retirement savings. Each participant may make pre-tax contributions based upon eligible compensation. The Company makes a contribution equal to 60% or 100% of each participant's pre-tax contributions, not to exceed 6%, of the participant's eligible compensation for the plan year. The Company's contributions totaled \$404,406, \$353,350 and \$301,794 for the years ended December 31, 1997, 1996 and 1995, respectively. As of December 31, 1997, there are 56,374 shares reserved to fund future contributions to the Plan.

### J. Environmental Commitments and Contingencies

The Company currently is participating in the investigation, assessment or remediation of three former gas manufacturing plant sites located in different jurisdictions, including the exploration of corrective action options to remove environmental contaminants. The Company has accrued liabilities for two of these sites, the Dover Gas Light and Salisbury Town Gas Light sites.



The Dover site's remediation costs are estimated at \$4.2 million in the Record of Decision ("ROD") issued by the Environmental Protection Agency ("EPA") in January 1998. The Company and General Public Utilities Corporation, Inc. ("GPU") were ordered by the EPA to fund or implement the ROD. During 1998, the Company will commence with the design phase. The Company has adjusted the liability associated with the Dover site from \$6.0 million to \$4.2 million. The Company has also recorded a regulatory asset in the same amount. The previous accrual of \$6.0 million was based on the original Record of Decision issued by the EPA in 1994.

The Company initiated litigation against one of the other potentially responsible parties for contribution to the remedial costs incurred by Chesapeake in connection with complying with the ROD. At this time, management cannot predict the outcome of the litigation or the amount of proceeds to be received, if any. Management believes that the Company will be equitably entitled to contribution from other responsible parties for a portion of the expenses to be incurred in connection with the remedies selected in the ROD. Management also believes that the amounts not so contributed will be recoverable in the Company's rates.

In cooperation with the Maryland Department of the Environment ("MDE"), in 1996 the Company completed construction and began remediation procedures at the Salisbury site. In addition, the Company began quarterly reporting of the remediation and monitoring results to the MDE. The Company has established a liability with respect to the Salisbury site of \$665,000 as of December 31, 1997. This amount is based on the estimated operating costs of the remediation facilities. A corresponding regulatory asset has been recorded, reflecting the Company's belief that costs incurred will be recoverable in rates.

Portions of the liability payouts for the Dover and Salisbury sites are expected to be over 30 and five-year periods, respectively. In addition, the Company has a site located in the state of Florida, which is currently being evaluated. At this time, no estimate of liability can be made. It is management's opinion that any unrecovered current costs and any other future costs incurred will be recoverable through future rates or sharing arrangements with other responsible parties.

At December 31,	1997	1996
Environmental Costs Incurred		
Delaware	\$5,317,380	\$4,423,843
Maryland	2,368,168	2,187,810
Florida	692,391	660,828
Total costs incurred	8,377,939	7,272,481
Less: Amounts, net of insurance proceeds, which have been approved for ratemaking treatment	(\$7,319,496)	(6,396,108)
Amounts pending ratemaking recovery	\$1,058,443	\$876,373

## K. Commitments and Contingencies

### FERC PGA

In the third quarter of 1995, Eastern Shore reached a settlement with the FERC pertaining to Eastern Shore's PGA methodology. Accordingly, Eastern Shore reversed a large portion of the estimated liability that had been accrued. This reversal contributed \$1,385,000 to pre-tax earnings, or \$833,000 to after-tax earnings, for the period.

### Other Commitments and Contingencies

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 of the Company.

**L. 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. 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
<b>1997</b>				
Operating Revenue	\$43,645,111	\$24,805,428	\$19,910,307	\$34,413,746
Operating Income	\$4,104,438	\$1,409,752	\$25,177	\$3,019,603
Net Income	\$3,366,113	\$692,841	(\$739,193)	\$2,363,185
Earnings per share:				
Basic	\$0.76	\$0.16	(\$0.17)	\$0.53
Diluted	\$0.72	\$0.15	(\$0.17)	\$0.51
<b>1996</b>				
Operating Revenue	\$49,026,542	\$25,213,979	\$19,637,074	\$36,335,814
Operating Income	\$6,667,499	\$1,084,392	(\$160,422)	\$2,518,536
Net Income	\$6,000,157	\$486,311	(\$747,779)	\$1,866,226
Earnings per share:				
Basic	\$1.37	\$0.11	(\$0.17)	\$0.42
Diluted	\$1.30	\$0.11	(\$0.17)	\$0.41

**Item 9. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure**  
None

**PART III****Item 10. Directors and Executive Officers of the Registrant**

Information pertaining to the Directors of the Company is incorporated herein by reference to the Proxy Statement, under "Information Regarding the Board of Directors and Nominees", dated and to be filed on or before March 30, 1998 in connection with the Company's Annual Meeting to be held on May 19, 1998.

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 Item 10 of Part I of this Form 10-K under "Executive Officers of the Registrant."

**Item 11. Executive Compensation**

This information is incorporated herein by reference to the Proxy Statement, under "Report on Executive Compensation", dated and to be filed on or before March 30, 1998 in connection with the Company's Annual Meeting to be held on May 19, 1998.

**Item 12. Security Ownership of Certain Beneficial Owners and Management**

This information is incorporated herein by reference to the Proxy Statement, under "Beneficial Ownership of the Company's Securities", dated and to be filed on or before March 30, 1998 in connection with the Company's Annual Meeting to be held on May 19, 1998.

**Item 13. Certain Relationships and Related Transactions**

This information is incorporated herein by reference to the Proxy Statement, under "Beneficial Ownership of the Company's Securities", dated and to be filed on or before March 30, 1998 in connection with the Company's Annual Meeting to be held on May 19, 1998.

**PART IV****Item 14. Financial Statements, Financial Statement Schedules, and Exhibits and Reports on Form 8-K****(a) The following documents are filed as a part of this report:**

## 1. Financial Statements:

- Accountants' Report dated February 12, 1998 of Coopers & Lybrand L.L.P., Independent Accountants
- Consolidated Statements of Income for each of the three years ended December 31, 1997, 1996 and 1995
- Consolidated Balance Sheets at December 31, 1997 and December 31, 1996
- Consolidated Statements of Cash Flows for each of the three years ended December 31, 1997, 1996 and 1995
- Consolidated Statements of Common Stockholders' Equity for each of the three years ended December 31, 1997, 1996 and 1995
- Consolidated Statements of Income Taxes for each of the three years ended December 31, 1997, 1996 and 1995
- Notes to Consolidated Financial Statements

## 2. The following additional information for the years 1997, 1996 and 1995 is submitted herewith:

- 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.

**(b) Reports on Form 8-K**

None.

**(c) Exhibits**

- |              |   |
|--------------|---|
| Exhibit 2(a) | Agreement and Plan of Merger by and between Chesapeake Utilities Corporation and Tri-County Gas Company, Inc., filed on the Company's Form 8-K, File No. 001-11590 on January 13, 1997, is incorporated herein by reference.  |
| Exhibit 3(a) | Amended Certificate of Incorporation of Chesapeake Utilities Corporation is incorporated herein by reference to Exhibit 3 of the Company's Quarterly Report on Form 10-Q for the period ended June 30, 1995, File No. 001-11590.  |
| Exhibit 3(b) | Amended Bylaws of Chesapeake Utilities Corporation, effective July 11, 1997, are incorporated herein by reference to Exhibit 3 of the Quarterly Report on Form 10-Q for the period ended June 30, 1997, File No. 001-11590.   |
| Exhibit 4(a) | 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. |

- Exhibit 4(b) 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.
- Exhibit 4(c) Directors Stock Compensation Plan adopted by Chesapeake Utilities Corporation in 1995 is incorporated herein by reference to the Company's Proxy Statement dated April 17, 1995 in connection with the Company's Annual Meeting held in May 1995.
- Exhibit 4(d) 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 Commission upon request.
- Exhibit 4(e) 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 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 Commission upon request.
- Exhibit 10(a) Service Agreement dated November 1, 1989, by and between Transcontinental Gas Pipe Line Corporation and Eastern Shore Natural Gas Company, is incorporated herein by reference to Exhibit 10 to the Company's Annual Report on Form 10-K for the year ended December 31, 1989, File No. 0-593.
- Exhibit 10(b) Service Agreement dated November 1, 1989, by and between Columbia Gas Transmission Corporation and Eastern Shore Natural Gas Company, is incorporated herein by reference to Exhibit 10 to the Company's Annual Report on Form 10-K for the year ended December 31, 1989, File No. 0-593.
- Exhibit 10(c) Service Agreement for General Service dated November 1, 1989, by and between Florida Gas Transmission Company and Chesapeake Utilities Corporation, is incorporated herein by reference to Exhibit 10 to the Company's Annual Report on Form 10-K for the year ended December 31, 1990, File No. 0-593.
- Exhibit 10(d) Service Agreement for Preferred Service dated November 1, 1989, by and between Florida Gas Transmission Company and Chesapeake Utilities Corporation, is incorporated herein by reference to Exhibit 10 to the Company's Annual Report on Form 10-K for the year ended December 31, 1990, File No. 0-593.
- Exhibit 10(e) Service Agreement for Firm Transportation Service dated November 1, 1989, by and between Florida Gas Transmission Company and Chesapeake Utilities Corporation, is incorporated herein by reference to Exhibit 10 to the Company's Annual Report on Form 10-K for the year ended December 31, 1990, File No. 0-593.
- Exhibit 10(f) Form of Service Agreement for Interruptible Sales Services dated May 11, 1990, by and between Florida Gas Transmission Company and Chesapeake Utilities Corporation, is incorporated herein by reference to Exhibit 10 to the Company's Annual Report on Form 10-K for the year ended December 31, 1990, File No. 0-593.

- Exhibit 10(g) Interruptible Transportation Service Agreement dated February 23, 1990, by and between Florida Gas Transmission Company and Chesapeake Utilities Corporation, is incorporated herein by reference to Exhibit 10 to the Company's Annual Report on Form 10-K for the year ended December 31, 1990, File No. 0-593.
- Exhibit 10(h) Interruptible Transportation Service Agreement dated November 30, 1990, by and between Florida Gas Transmission Company and Chesapeake Utilities Corporation, is incorporated herein by reference to Exhibit 10 to the Company's Annual Report on Form 10-K for the year ended December 31, 1990, File No. 0-593.
- Exhibit 10(i) Executive Employment Agreement dated March 26, 1997, by and between Chesapeake Utilities Corporation and each Ralph J. Adkins and John R. Schimkaitis is incorporated herein by reference to Exhibit 10 to the Company's Quarterly Report on Form 10-Q for the period ended June 30, 1997, File No. 001-11590.
- Exhibit 10(j) Form of Performance Share Agreement dated January 1, 1998, pursuant to Chesapeake Utilities Corporation Performance Incentive Plan by and between Chesapeake Utilities Corporation and each of Ralph J. Adkins and John R. Schimkaitis is filed herewith.
- Exhibit 10(k) Chesapeake Utilities Corporation Cash Bonus Incentive Plan dated January 1, 1992, is incorporated herein by reference to Exhibit 10 to the Company's Annual Report on Form 10-K for the year ended December 31, 1991, File No. 0-593.
- Exhibit 10(l) Chesapeake Utilities Corporation Performance Incentive Plan dated January 1, 1992, is incorporated herein by reference to the Company's Proxy Statement dated April 20, 1992, in connection with the Company's Annual Meeting held on May 19, 1992.
- Exhibit 10(m) Form of Stock Option Agreement dated January 1, 1998, pursuant to Chesapeake Utilities Corporation Performance Incentive Plan by and between Chesapeake Utilities Corporation and each of Michael P. McMasters, Stephen C. Thompson, William C. Boyles, Philip S. Barefoot, Jeremy D. West, William P. Schneider and James R. Schneider, is filed herewith.
- Exhibit 12 Computation of Ratio of Earning to Fixed Charges, filed herewith.
- Exhibit 21 Subsidiaries of the Registrant, filed herewith.
- Exhibit 23 Consent of Independent Accountants, filed herewith.

## 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/ RALPH J. ADKINS  
Ralph J. Adkins  
Chairman of the Board and Chief Executive Officer  
Date: March 20, 1998

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,  
Chief Executive Officer and Director  
Date: March 20, 1998

/S/ JOHN R. SCHIMKAITIS  
John R. Schimkaitis, President,  
Chief Operating Officer and Director  
Date: March 20, 1998

/S/ MICHAEL P. MCMASTERS  
Michael P. McMasters, Vice President,  
Chief Financial Officer and Treasurer  
(Principal Financial Officer)  
Date: March 20, 1998

/S/ RICHARD BERNSTEIN  
Richard Bernstein, Director  
Date: March 20, 1998

/S/ WALTER J. COLEMAN  
Walter J. Coleman, Director  
Date: March 20, 1998

/S/ JOHN W. JARDINE, JR.  
John W. Jardine, Jr., Director  
Date: March 20, 1998

/S/ RUDOLPH M. PEINS, JR.  
Rudolph M. Peins, Jr., Director  
Date: March 20, 1998

/S/ ROBERT F. RIDER  
Robert F. Rider, Director  
Date: March 20, 1998

/S/ JEREMIAH P. SHEA  
Jeremiah P. Shea, Director  
Date: March 20, 1998

/S/ WILLIAM G. WARDEN, III  
William G. Warden, III, Director  
Date: March 20, 1998

**CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES**  
**SCHEDULE II**  
**VALUATION AND QUALIFYING ACCOUNTS**

**FOR THE YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995**

COLUMN A	COLUMN B	COLUMN C		COLUMN D	COLUMN E
Description	Balance at Beginning of Period	----- Additions -----		Deductions	Balance at End of Period
		Charged to Costs and Expense	Charged to Other Accounts		
Valuation accounts deducted from assets to which they apply for doubtful accounts receivable:					
1997 .....	\$392,412	\$203,624	\$68,038 (B)	(\$332,299) (A)	\$331,775
1996 .....	\$309,955	\$364,622	\$55,631 (B)	(\$337,796) (A)	\$392,412
1995 .....	\$202,152	\$328,012	\$43,151 (B)	(\$263,360) (A)	\$309,955

**Notes:**

(A) Uncollectible accounts charged off.

(B) Recoveries.

**CHESAPEAKE UTILITIES CORPORATION AND SUBSIDIARIES**  
**EXHIBIT 12**  
**COMPUTATION OF RATIO OF EARNINGS TO FIXED CHARGES**

	For the Years Ended December 31,		
	1997	1996	1995
Income from continuing operations	\$5,682,946	\$7,604,915	\$7,593,506
Add:			
Income taxes	3,599,430	4,085,610	3,865,179
Portion of rents representative of interest factor	140,491	129,223	182,211
Interest on indebtedness	3,269,479	2,907,314	2,848,567
Amortization of debt discount and expense	119,401	120,345	109,399
Earnings as adjusted	<u>\$12,811,747</u>	<u>\$14,847,407</u>	<u>\$14,598,862</u>
Fixed Charges			
Portion of rents representative of interest factor	\$140,491	\$129,223	\$182,211
Interest on indebtedness	3,269,479	2,907,314	2,848,567
Amortization of debt discount and expense	119,401	120,345	109,399
Fixed Charges	<u>\$3,529,371</u>	<u>\$3,156,882</u>	<u>\$3,140,177</u>
Ratio of Earnings to Fixed Charges	<u>3.63</u>	<u>4.70</u>	<u>4.65</u>



**CHESAPEAKE UTILITIES CORPORATION**  
**EXHIBIT 21**  
**SUBSIDIARIES OF THE REGISTRANT**

<u><b>Subsidiaries</b></u>	<u><b>State Incorporated</b></u>
Eastern Shore Natural Gas Company	Delaware
Sharp Energy, Inc.	Delaware
Chesapeake Services Company	Delaware
United Systems, Inc.	Georgia
Tri-County Gas Company, Inc.	Maryland
Eastern Shore Real Estate	Maryland
<u><b>Subsidiary of Eastern Shore Natural Gas Company</b></u>	<u><b>State Incorporated</b></u>
Dover Exploration Company	Delaware
<u><b>Subsidiaries of Sharp Energy, Inc.</b></u>	<u><b>State Incorporated</b></u>
Sharpgas, Inc.	Delaware
Sharpoil, Inc.	Delaware
<u><b>Subsidiaries of Chesapeake Service Company</b></u>	<u><b>State Incorporated</b></u>
Skipjack, Inc.	Delaware
Capital Data Systems, Inc.	North Carolina
Currin and Associates, Inc.	North Carolina
Chesapeake Investment Company	Delaware

## CONSENT OF INDEPENDENT ACCOUNTANTS

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We consent to the incorporation by reference in the Prospectuses of Chesapeake Utilities Corporation on Form S-2 (File No. 33-26582), Form S-3 (File Nos. 33-28391 and 33-64671) and Form S-8 (File No. 33-301175) of our report dated February 12, 1998 on our audits of the consolidated financial statements and the consolidated financial statement schedules of Chesapeake Utilities Corporation as of December 31, 1997 and 1996 and for each of the three years in the period ended December 31, 1997 included in this Annual Report on Form 10-K.

COOPERS & LYBRAND L.L.P.

Baltimore, Maryland  
March 23, 1998

*Upon written request,  
Chesapeake will provide, without  
charge, a copy of any exhibit to  
Chesapeake's Annual Report on  
Form 10-K not included herewith.*