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Deloitte Oil & Gas Mergers and Acquisitions Report – Midyear 2014

The deal market may be
poised for a rebound

Deloitte Center
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Vice Chairman's introductory comments

For the oil and gas industry, the first half of 2014 saw a continuation of many of the trends present in 2013. After the flurry of deal activity in 2012, companies have focused on cost containment and organic growth. In the exploration and production (E&P) sector, in particular, producers have been looking to ensure they have the right mix of properties in their portfolio, and as a result, most deal activity has centered on rationalizing their property mix rather than expanding their asset base.

Faced with these organic growth opportunities, buyers are weighing each potential new acquisition with respect to their current asset mix in order to extract the maximum value from each deal, and as a result, deals are being done more slowly. While a below-average deal count persisted in the latter half of 2013, the decline has begun to slow and may begin to reverse in the second half of 2014.

Commodity prices were more volatile this year, although they did remain high. Mounting geopolitical unrest could put upward pressure on oil prices for the remainder of the year. Higher prices are good for producers but, it may make them less likely to sell assets. Natural gas prices are also enjoying a period of stability. The prospect of increased demand for future liquefied natural gas (LNG) exports could encourage deal activity this year as more producers decide to increase their gas exposure.

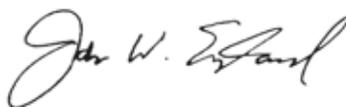
The United States and Canada remained the center of deal activity in the first half of 2014 – accounting for 61 percent of all transactions globally. Much of the investment in the U.S. continued to focus on unconventional shale projects, while Canada saw a move to more conventional plays and away from oil sands.

The oilfield services sector saw its deal count slip, even as the overall value of transactions rose. In the future, we may see a rising deal count as larger oil and gas companies look for strategic oilfield service acquisitions to add specialized technologies and services to their portfolios.

The midstream sector reported the most dramatic slowdown in merger and acquisition (M&A) activity during the first half of the year. Much of the demand for new pipelines and processing facilities needed to keep pace with the growth of unconventional plays in North America is being met by new construction which is suppressing acquisition activity in the sector.

The refining and marketing sector showed the biggest growth in deal value on a percentage basis, rising by 170 percent. This was primarily driven by large transactions focused on the retail side of the business. Retail may continue to drive deal activity due to the strengthening economic recovery.

Overall, companies continue to look to acquire resources with a focused approach, and private equity continues to search for new oil and gas investments. Companies also continue to rationalize their asset portfolios in order to contain costs and focus on organic growth from recent acquisitions. After a slow start to the year, new second-quarter deal activity may be a harbinger of a revitalized deal market in the second half of the year.



John England
Vice Chairman
U.S. Oil & Gas Leader
Deloitte LLP

Industry overview

M&A deal value increases as activity diversifies across sectors and geographies

While oil and gas companies have refocused on organic growth and rationalizing their resource portfolios over the past four quarters, the first half of 2014 ended with signs that deal activity may accelerate in the latter half of the year. The rapid expansion of onshore unconventional reserves in the United States was a key driver of deal activity that reached its peak at the end of 2012. Since then, producers have focused on developing the properties they acquired, which has led to below-average deal activity that is only now showing signs of turning around.

While the total number of deals in the first half of 2014 dipped by one, to 299, from the 300 completed in the same period a year earlier, the combined value of all deals globally increased 38 percent, to \$141 billion. The United States and Canada accounted for 61 percent of all deal activity, but their dominance in the global deal market has fallen from 67 percent in 2012. In the first half of the year, both Asia and South America saw increases in their share of the deal count rising nearly 20 percent and 50 percent, respectively.

Two of the largest of such transactions involved Australian companies. Royal Dutch Shell announced plans to sell most of its stake in Australia's Woodside Petroleum

for \$5.7 billion, subject to shareholder approval, and Cheung Kong Group agreed to acquire Envestra, an Australian natural gas producer, for \$3.4 billion. Increased deal activity in Asia and South America comes as U.S. transactions continue to decline, reflecting an ongoing strategy for many U.S. onshore producers to concentrate on developing properties they acquired in prior years. As these companies work through drilling inventories, there is generally an emphasis on operating efficiencies and lower costs, which is suppressing overall deal counts.

"Management teams are generally focused on organic growth and cost containment," said John England, vice chairman, U.S. Oil & Gas Leader, Deloitte LLP. "They have a drilling inventory that will last for several years, so they would rather put their money into development than acquisitions."

As 2014 progressed, deal values showed signs of recovery. During the first five months of the year, deal values appeared to be headed for another decline, but turned around in June, thanks to large deals like Royal Dutch Shell's planned sell down to Woodside Petroleum and Williams Companies' \$6 billion purchase of an interest in Access Midstream Partners from Global Infrastructure Partners II.

Figure 1. Global oil and gas M&A deals by value and count



Note: M&A activity examined in this report represents announced mergers and acquisitions involving oil and gas companies between the first quarter 2013 and the second quarter 2014, with values greater than \$10 million, including transactions with no disclosures on reserves and/or production. Our analysis has excluded transactions with no announced value as well as transactions between affiliated companies, to provide a more accurate picture of M&A activity in the industry. Deloitte's methodology takes a deeper look into the M&A transaction data.

Source: PLS Inc. and Derrick Petroleum Services Global M&A Database



“Largely because of geopolitical unrest that has curtailed production from Libya, Iraq, and Iran, commodity prices have remained relatively high for the first half of the year, and expectations for continued upward pressure on prices for the remainder of the year may make producers less likely to part with assets,” Mr. England said. Meanwhile, natural gas prices have remained stable, and the potential for increased demand from U.S. exports of LNG may draw some new buyers to the market as they look to increase their exposure to gas.

While higher crude prices benefit producers, development costs have continued to rise, putting pressure on company earnings and free cash flow. Combined with the need to deploy cash for developing existing properties, companies are left with less cash for acquisitions. Lower profit per barrel means more properties fall below the return threshold for which buyers are looking. “There is some disparity between the asking price by sellers and what buyers are willing to pay,” said Melinda Yee, partner, M&A Transaction Services, Deloitte & Touche LLP.

That disparity is evident in a 10 percent decline in U.S. transactions. The number of deals fell to 122 in the first half of 2014, down from 136 for the same period in 2013.



Producers in U.S. shale plays have also received the message that investors will no longer reward them simply for expanding their shale holdings. In the early days of the hydraulic fracturing boom, the stock market celebrated companies that moved into shale plays, regardless of their cost structures. Now, investors have developed greater rationale in evaluating producers, requiring them to generate greater returns from their shale investments. Shareholder concerns over performance and returns appear to be putting pressure on companies to divest assets through spin-offs or sales, which may help contribute to a rise in deal activity in the second half of 2014.

The Canadian deal count rose 15 percent in the first half of 2014, compared with the same period a year earlier. The increase came even as Canadian producers have struggled with the lack of major pipelines that can access key markets such as the United States to the south or exports on the coasts. Large producers, such as Encana, like their counterparts in the United States, have generally focused on repositioning their assets for greater efficiency. At the same time, the government has placed restrictions on investment by foreign state-owned companies. "It hurts us as a country and it causes the foreign investors to pause a little bit," said Charles Knight, partner, M&A Transaction Services, Deloitte Canada.

The increase in global deal value in June could be the first indication that more activity will follow in the second half of the year. Private equity continues to target oil and gas investments, especially the oilfield services and midstream sectors. Interest rates are forecast to remain low for the remainder of the year, and companies' rising stock prices mean potential buyers may be able to access additional capital through stock appreciation.



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Exploration and production

North American shale plays remain a key driver of deals

The number of exploration and production (E&P) transactions increased 13 percent, rising by 26 deals to 231 in the first half of 2014, compared with 205 for the first half of 2013. Deal values also surged by more than 90 percent during the same period, to almost \$100 billion from \$52 billion. After a quiet start to the year, E&P deals accelerated in the second quarter, accounting for half of the 10 largest transactions in the quarter.

North American shale plays continued to dominate the deal market. In the United States and Canada, unconventional assets made up 47 percent of all E&P transactions. The past frenzy among companies to get into shale has subsided as some of the bigger players have become more cautious, thereby forcing companies to concentrate on optimizing their portfolios and containing their costs. As drilling costs for shale production have risen, companies have become more selective in how they invest their capital. As a result, the number of deals in the United States slipped by two in the first half 2014, compared with the same period a year earlier in 2013.

Oil continued to dominate upstream deals, thanks to continued strong crude prices. The price differential

between West Texas Intermediate crude and world benchmarks narrowed during the first half of the year as additional infrastructure came online, thereby easing bottlenecks. According to data from Morgan Stanley, the average production cost for a barrel of oil declined in 2013 to nearly \$6 per barrel from \$8.50 in 2012 – a sign that producers’ cost containment efforts are bearing fruit. However, rising development costs and taxes are pushing up the cost per barrel to nearly \$70 from \$63 in 2011. These rising costs are squeezing margins as reflected in free cash flows, which have narrowed to just over \$2 per barrel from nearly \$5 per barrel in 2011, even as revenue per barrel has risen.¹

Producers have rationalized their portfolios by concentrating on fewer fields or focusing on reservoirs where they can generate the greatest returns. For example, Freeport-McMoRan sold assets in the Eagle Ford Shale of South Texas to Encana for \$3.1 billion. The deal is expected to allow Freeport-McMoRan to emphasize its Gulf of Mexico development while giving Encana a foothold in a lucrative North American shale play. “You’re going to see companies selling assets to make sure they are investing the capital that they have in their most important projects,” said Ms. Yee.

Figure 2. Global E&P M&A deals by value and count



1. Morgan Stanley, "Global Energy Teach-In", May 2014.

Source: PLS Inc. and Derrick Petroleum Services Global M&A Database



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Partner
Deloitte & Touche LLP

Adding to the concern going forward, hydraulic fracturing continues to draw an increased level of public and regulatory scrutiny, with some states and cities issuing moratoriums on new drilling or putting referendums on hydraulic fracturing before voters. Increased restrictions could further strain the cost equation for producers in the shale plays.

Offshore in the Gulf of Mexico, some larger producers and drilling companies have been shedding shallow-water assets to focus on larger projects, both offshore in lucrative deepwater plays and onshore in shale plays. “The trend could yield some consolidation among smaller producers in the shallow water,” Ms. Yee said. Private equity investors have shown interest in the continental shelf. Earlier this year, private equity backed, Fieldwood Energy acquired the offshore assets of SandRidge Energy, while SandRidge will retain a 2% overriding royalty interest in exploration projects in the deep Micoene at Green Canyon and South Pass.

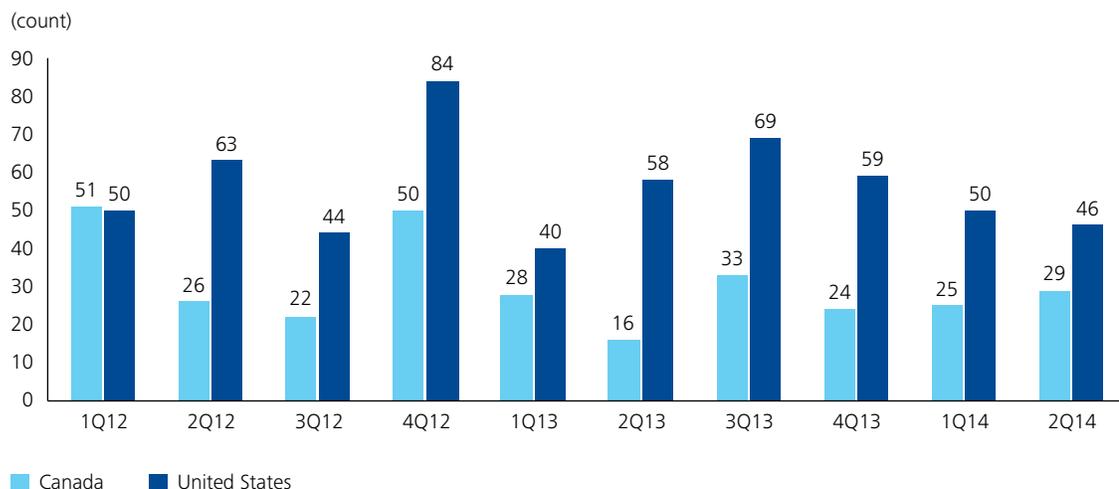
In Canada, the E&P deal count rose by 23 percent in the first half of the year as producers focused on conventional oil reserves. Devon Energy acquired and developed a large portfolio of conventional assets over the past 15 years before selling them earlier this year to Canadian Natural Resources for \$2.8 billion as part of Devon Energy’s efforts to shore up its North American onshore portfolio.

Despite the increase, Canada remains constrained by a lack of pipeline capacity, and recent court rulings regarding land rights for First Nations could further delay construction of new projects. “Canada is moving very slowly in addressing these issues, and it’s causing a pause with inbound capital,” said Jeff Lyons, partner, Deloitte Canada.

Deal activity has cooled in Canada’s vast oil sands reserves as producers have struggled with rising costs, in part because of stricter environmental regulations. Even with oil at more than \$100 per barrel, some large producers have been canceling projects because higher costs have crimped returns. “It’s economically challenging in terms of the return,” Mr. Lyons said. “Cost escalation is causing oil sands participants to rethink the economics and go forward with projects. That’s why you’re not seeing a lot of capital flowing into oil sands.”

Canada continues to attract foreign investment, albeit at a slower pace than in previous years, partly because it is free of the export restrictions that are present in the United States. For example, Malaysia’s PETRONAS has invested in Canadian natural gas across the value chain, acquiring interests in upstream reserves and pipelines, and is now proposing an LNG export terminal on the West Coast of Canada.

Figure 3. U.S. and Canada E&P M&A deals by count



Source: PLS Inc. and Derrick Petroleum Services Global M&A Database

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– Jeff Lyons
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Deloitte Canada



Oilfield services

Margin pressure from the upstream sector may drive consolidation

Deal activity in the oilfield services sector cooled in the first half of 2014 as cost containment efforts in the E&P sector put pressure on margins. The number of deals fell by 35 percent, to 37 in the first half of 2014 from 57 over the same period last year. Deal value, however, increased by 22 percent, or \$14 billion, thanks in part to three large deals that ranked among the top 10 oil and gas deals so far this year.

Two of the transactions – JACCAR Holdings’ \$3.8 billion purchase of Bourbon, an operator of service vessels for the offshore industry, and SNC-Lavalin Group’s \$2.9 billion purchase of the engineering firm Kentz Corporation – were in Europe. The other large deal, the \$2.9 billion combination of C&J Energy Services with Nabors Industries’, was in North America.

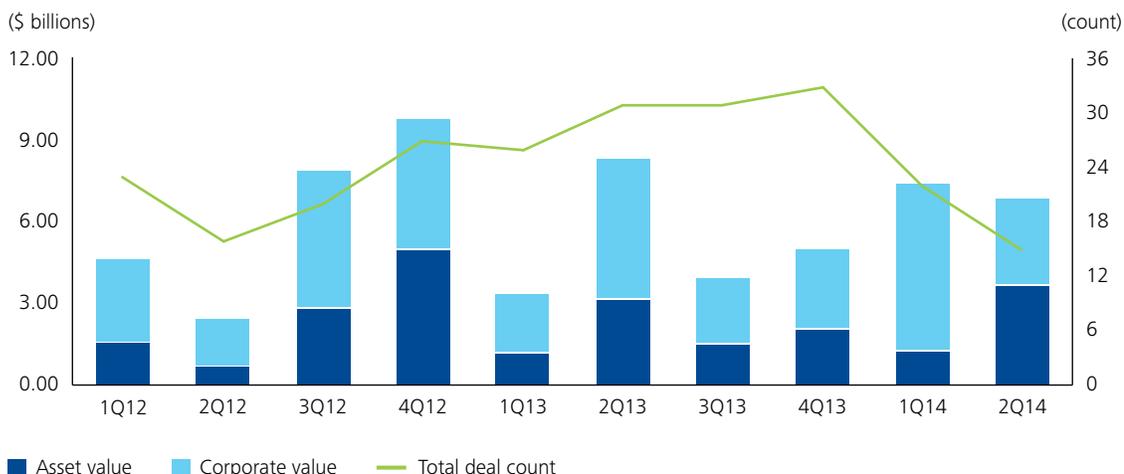
Asia accounted for far more large deals in the first half of 2014, in part because the largest oilfield service providers in North America have completed a number of sizable acquisitions in recent years. Since 2012, North America’s percentage of the oilfield services deal market has shrunk to 41 percent in the first half 2014 from 65 percent in 2012, while Asia’s has increased to 11 percent in the first half of 2014 from 5 percent in 2012 based on announced transactions with deal values over \$10 million.

While the North American market has slowed, some companies continue to look for specialized targets that can enhance their service offerings, and the margin pressure from the E&P sector is likely to drive additional consolidation among middle-market players. “There’s a lot of consolidation among the smaller companies, and you might continue to see big companies engaged in what you might call a defensive play in which they spend several million to buy a smaller company in a technical niche so that a competitor won’t get it,” said Jed Shreve, principal, Deloitte Transactions and Business Analytics LLP.

Meanwhile, the larger companies are likely to continue their focus on deepwater drilling, where contracts remain lucrative, moving away from the shallow water, in which day rates have been volatile. In recent years, large offshore drillers such as Transocean and Noble have sold or announced plans to spin off shallow-water assets and to focus on deepwater projects globally.

The oilfield services sector continues to attract the interest of private equity investors, especially among funds looking for ways to diversify their industry base and invest in energy. The oilfield services sector has many fragmented players that are in need of capital to grow, which is ideal for private equity investment.

Figure 4. Global oilfield services M&A deals by value and count



Source: PLS Inc. and Derrick Petroleum Services Global M&A Database



In addition, political reforms in Mexico that will allow foreign direct investment in its energy production for the first time since the 1930s may help revitalize deal activity in North America. Companies already are positioning themselves to take advantage of the changes. For instance, Seadrill established a 50/50 joint venture called SeaMex with investment fund Fintech Advisory in a \$488 million deal to manage jack-up drilling units working for Pemex and pursue other opportunities in Mexico and Latin America.

At the same time, some oilfield services companies have found themselves under pressure from activist shareholders, who are urging them to boost earnings. "The pressure has been ratcheted up," said Eric Andreozzi, managing director, Deloitte Corporate Finance LLC. "Companies that have good but not great earnings and a lot of cash are feeling the pressure to grow through acquisitions because there's not a lot of organic growth in the market right now."

"Deal activity in oilfield services tends to be more seasonal than other sectors of the oil and gas industry. Historically, the third and fourth quarters are always the highest," Mr. Shreve said. If the trend continues this year, there could be an increase in deal activity in the second half of the year for the sector.

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Principal

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Midstream

Despite slowdown in deal making, infrastructure demands remain strong

The midstream sector recorded the most dramatic slowdown in deal activity during the first half of 2014. After a flurry of transactions in 2012 and 2013, many larger midstream companies found fewer opportunities to grow their distributed cash flow through acquisitions. Deal value tumbled 66 percent, or \$21 billion, from \$32 billion in the first half of 2013 to \$11 billion in the first half of this year. The number of deals fell to 14 from 28 during the same period. Williams' acquisition of the Access Midstream pipeline interest was the only midstream deal among the top 10 oil and gas transactions in the first half of 2014.

South America was the lone region of the globe that reported an increase in midstream transactions, with five deals in the first half of this year, compared with one for the first half of 2013. The rise in M&A activity in South America in 2014 was driven by a flurry of deal activity involving Transportadora de Gas del Perú (TGP) and Compañía Operadora de Gas del Amazonas (COGA). TGP

is the largest transporter of natural gas and natural gas liquids in Peru, while COGA is responsible for the operation and maintenance of TGP's infrastructure.

With the proliferation of upstream activity in North America, pricing for midstream assets has risen sharply, and the increase may have put a damper on deal activity. "Companies may have slowed down a bit as prices reached a crescendo," said Jason Spann, partner, M&A Transaction Services, Deloitte Tax LLP.

Higher asset prices have encouraged more would-be sellers to seek investment directly from the public. About 16 master limited partnerships (MLPs) filed or announced initial public offerings (IPOs) in the first half of the year, more than went public in all of 2007.² The unique tax structure of MLPs makes them popular with investors in a low-interest-rate environment. "IPOs are another source of competition for deals that buyers have," Mr. Spann said.

Figure 5. Global midstream M&A deals by value and count



2. "MLPData.com," accessed July 18, 2014, <http://mlpdata.com/issuanceunits>.

Source: PLS Inc. and Derrick Petroleum Services Global M&A Database

While interest rates are forecast to remain low for the remainder of the year, any increase in rates could reduce investors' appetites for MLPs. The Internal Revenue Service (IRS) recently enacted a moratorium on issuing rulings for qualifying income to new MLPs. "The IRS's review of its policies toward MLPs is not expected to result in significant changes, but it may make it more difficult for some partnerships to move forward with IPO plans," Mr. Spann said.

In the meantime, the need for additional pipelines and processing facilities is likely to persist, driving demand for new construction. Private equity continues to flow into the sector, which may result in additional acquisitions and public offerings once sufficient scale is developed. "We believe there is a backlog of transactions out there that will be acted upon," Mr. Spann said. "Those assets should start to move. We would expect to see an uptick in midstream activity at some point as long as the markets remain strong. Long term, the consolidation trend is expected to continue."



“Companies may have slowed down a bit as prices reached a crescendo.”

– Jason Spann
Partner
Deloitte Tax LLP

Refining and marketing

Robust activity driven by an increase in retail transactions

The refining and marketing sector showed robust growth in the first half of 2014, both in terms of deal count and deal value, compared with the same period in 2013. The number of deals increased by seven to 17, and the total value of transactions rose to \$17 billion from \$6.3 billion, an increase of 170 percent. Retail deals account for a rising share of refining and marketing transactions primarily driven by expectations for economic recovery in the United States and markets in Asia, such as Australia. While retail deals have averaged around two deals per quarter since 2012, retail

deal activity surged in the second quarter of 2014 to eight deals. Two of the largest M&A deals announced in 2014 were refining and marketing deals both in the retail sector. Cheung Kong's purchase of Australia's Envestra for \$3.4 billion and Marathon Petroleum's acquisition of Hess Corp.'s retail assets for \$2.9 billion.

The Marathon-Hess deal may represent a broader trend in the refining and marketing sector, which is based on the economic recovery in the United States. "The focus

Figure 6. Global refining and marketing M&A deals by value and count





“The focus has generally shifted to retail and marketing because of the expected economic recovery in the United States.”

– Trevear Thomas
Principal
Deloitte Consulting LLP

has generally shifted to retail and marketing because of the expected economic recovery in the United States,” said Trevear Thomas, principal, M&A Consulting Services, Deloitte Consulting LLP. “In the United States, that’s the primary catalyst for transactions.”

The rising preponderance of retail deals has also been enabled by a decline in refining deals, which have fallen from eight in 2012 to just two in 2013. There have been no refining deals with an announced value thus far in 2014. This decline is primarily a result of the rationalization of refining assets that most large diversified companies have already completed, and it is unlikely they will be selling additional holdings unless they are underperforming assets or there are strategic reasons. However, the increase in the number of independent refiners in North America will likely create an appetite for additional deals in the future. “Scale will continue to be an important driver and may serve as a catalyst for consolidation in the mid to long term.” Mr. Thomas said.

Similarly, much of the refining and marketing deal activity in international markets also focus on the retail side of the business, rather than refining. However, because of the large capital requirements and the thin margins in the sector, transaction levels are unlikely to change significantly for some time. “There doesn’t appear to be a catalyst for increased deal activity,” Mr. Thomas said. “The market fundamentals are currently not there for consolidation to be attractive.”

Outlook

The deal market is poised for growth in the second half of the year

The uptick in deal activity in June of this year could signify a stronger deal market in the second half of the year. Upward pressure on commodity prices is likely to drive more transactions, and private equity investors, in particular, are likely to continue to show interest and be a source of capital. Margin pressure on oilfield service companies, as a result of continued cost containment in the upstream sector, could drive additional consolidation, particularly among smaller, regionally focused participants.

Political reform in Mexico offers the first real promise of opening the country's vast reserves to foreign investment for the first time since the government nationalized the oil industry in 1938. North American producers, in particular, are beginning to look for opportunities that may emerge as Mexico initiates foreign participation in new projects. "That could be a game changer for North America," said Robin Mann, partner, Resource Evaluation & Advisory, Deloitte Canada. "Mexico is really a big unknown for a lot of people right now." The opportunity is not limited solely to producers. While the United States currently exports gas to Mexico, the change in the political climate is likely to create opportunities for midstream and oilfield service providers as the industry addresses the country's large infrastructure needs.

At the same time, the United States is moving closer to the possibility of exporting LNG, which, if realized, could drive additional investment interest in natural gas. Additionally, the vast need for infrastructure in shale plays like Eagle Ford, Marcellus, and Bakken is likely to continue demand for capital in the midstream sector.

The United States and Canada continue to be at the center of M&A deal activity and will likely continue to drive investment across the value chain. At the same time, deal activity in markets such as Asia and South America are likely to continue to experience above-average deal activity as market participants seek to capitalize on opportunities globally.

Across the oil and gas industry, the deal market may be primed for an increase in activity as companies seek more capital to fund North America's ongoing energy renaissance. The level of investment needed to maintain or increase current production and maintain reserve replacement will likely continue to drive capital into shale plays, oil sands, conventional projects, as well as the infrastructure required to support them. Cost containment efforts in the upstream sector may increase margin pressure on oilfield services that could trigger additional consolidation in the second half of the year among smaller regional service providers. Finally, a strengthening U.S. economy also bodes well for deal activity in the refining and marketing sector.

In 2014, deal values received a boost in the second quarter, driven by several large transactions that reversed what had been a downward trend over the first five months of the year. The second-quarter surge in deal value could be among the first signs of increased deal activity in the second half of the year.

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