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ASSET MANAGEMENT

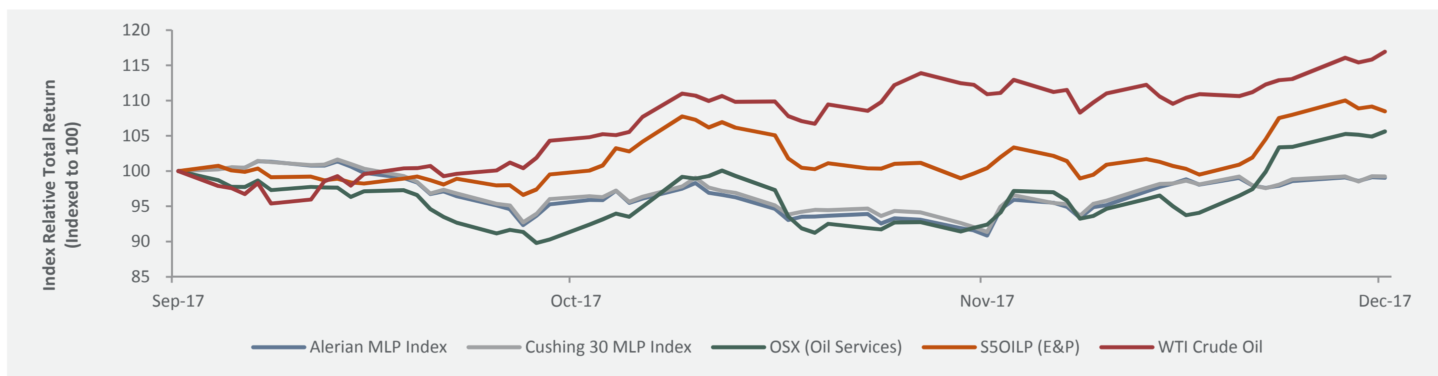
January | 2018

2017 Fourth Quarter Midstream Energy Market Review and 2018 Outlook

Dear Investors,

Investor frustration continued to linger into the fourth calendar quarter of 2017 ("the period"), as the performance of the midstream energy sector experienced yet another quarter of elevated volatility and negative total returns. The market cap-weighted Alerian MLP Index (AMZ) produced a –0.95% total return for the period, while the equal-weighted Cushing® 30 MLP Index (MLPX) produced a –0.78% total return. This negative performance is admittedly difficult to reconcile with the continued strength in the price of crude oil, which was up +16.93% for the period, as measured by the price of West Texas Intermediate crude oil. In accordance with the move in crude oil, the more commodity sensitive components of the energy sector delivered positive returns for the quarter, with the S&P 500 Oil & Gas Exploration and Production Index ("S5OILP") producing a +8.48% total return, and the Philadelphia Oil Service Sector Index ("OSX") producing a +5.62% total return.

Fourth Quarter 2017 Performance for Select Indices



Note: Represents relative price performance from September 30, 2017 through December 31, 2017. Indexed to 100.
Source: Bloomberg. PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

We were optimistic heading into 2017, and throughout the year we continually pointed to the many, significant and real, positive fundamental drivers for which investors seemed to give little credit or ignored completely. Simply put, we believe the midstream sector is and will continue to benefit as the critical link between the record high and rising supply of U.S. hydrocarbons (crude oil, natural gas and natural gas liquids production) and the record high and rising demand for U.S.-sourced hydrocarbons (both domestic and international demand).[1] However, despite the underlying fundamental environment improvement throughout 2017, the AMZ hit a new low for the year on November 29th. Despite a myriad of issues, we find it interesting that most arguments relate to the "MLP model" itself (i.e. corporate structure, capital funding strategy, payout ratios, LP/GP complexity, corporate governance, etc.), as opposed to underlying energy sector fundamentals, the positives of which are increasingly difficult to deny.

We believe the current setup provides investors with an interesting opportunity. If, as we believe, the primary driver for 2017 weakness was "asset class"-specific structural issues (i.e. not sector fundamentals), the resolution of these issues could serve as a powerful tailwind for future returns. As we look ahead in 2018, we believe the midstream energy sector is approaching the end of structural simplifications, shifting capital allocation/funding strategies and dividend/distribution resets. Although there may still be some outstanding transactions to come, management teams have spent the last two years addressing these structural concerns and significant advancements have been made.

With the structural evolution of the asset class progressing, a wider group of investors (both institutional and retail) may take a renewed look at the sector. When they do, we believe they will find a simpler, healthier asset class supported by compelling valuations and underlying drivers that continue to point positively.

8117 Preston Road, Suite 440, Dallas, TX 75225
(214) 692-6334 (phone) | (214) 219-2353 (fax)
www.cushingasset.com | info@cushingasset.com

AMZ Established its 2017 Low during the Period

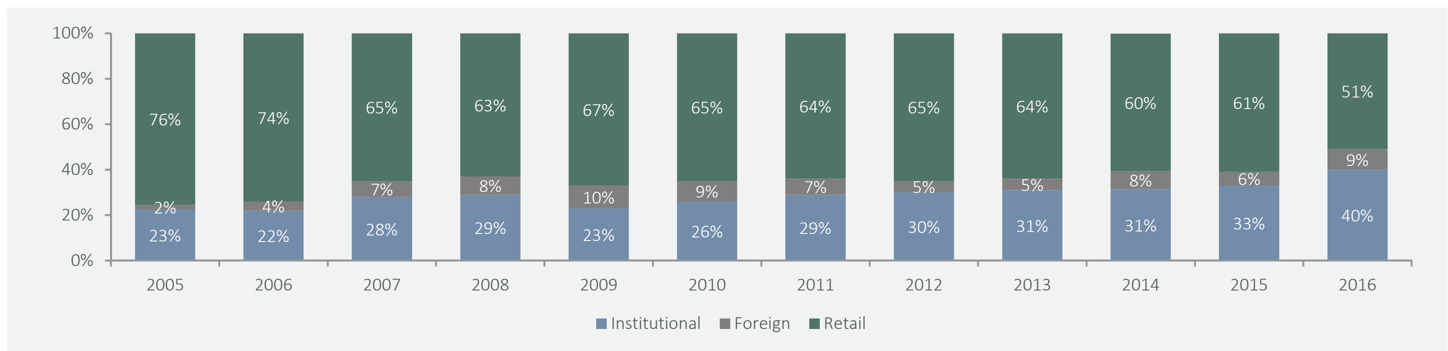
MLP performance, as measured by the AMZ, hit a new low for the year on November 29th. We believe there were many factors to blame:

- several more distribution cuts;
- reduced (or halted) distribution growth rates;
- valuation concerns regarding another General Partner Incentive Distribution Right ("IDR") buyout;
- rising costs of equity capital;
- funding concerns in the face of anemic MLP product fund flows;
- fears of increasing competitive forces driven by new project proposals and competition from private equity (particularly in the Permian Basin);
- and concerns over capital discipline and project returns.

Furthermore, as the end of the year approached, MLPs suffered from tax status uncertainties related to the "Tax Cuts and Jobs Act," and finally, tax loss harvesting as the midstream sector was one of the few sectors with negative performance for 2017.

While there was no shortage of investor concerns during the period, we believe the low, representing a –11% price decline from September 30th and a –20% price decline from the beginning of the year, was primarily the result of investor reaction (and possible misunderstanding) regarding the ongoing shift in midstream corporate strategy in response to the ongoing shift in the investor base (shown in the chart below) and concurrent evolution in investor preferences.

MLP Ownership Composition



Source: "Midstream/MLPs: Positive Outlook for '18." Wells Fargo Securities. January 11, 2018.

Similar to the investor pressure exerted on exploration and production ("E&P") management teams we discussed in our third quarter 2017 letter, an increasingly "institutional" investor base is demanding reform on corporate structure, capital allocation and funding models. Specifically, these investors generally focus on and/or prefer self-funding capital strategies, lower distribution/dividend payout ratios, more efficient costs of capital (i.e. IDR elimination), simplified corporate structures and strong corporate governance (i.e. GP/LP conflict elimination), multiples-based valuation metrics (as opposed to yield-based) and returns-based corporate measures (i.e. ROIC).

As such, we believe the vast majority of corporate actions during the fourth quarter (and resulting equity weakness) were a result of shifting investor preferences, as opposed to weakening energy sector fundamentals. Notably, MLP bellwether Enterprise Products Partners, LP (NYSE: EPD) lowered its distribution growth rate outlook during the period in an effort to become self-funding (i.e. no reliance on the equity markets to fund growth). Genesis Energy, LP (NYSE: GEL) announced a 31% distribution cut during the period in an effort to de-lever its balance sheet, become self-funding and potentially institute a unit repurchase program at some point in the future. And finally, MPLX, LP (NYSE: MPLX) announced the elimination of its GP economic interests and IDRs in order to reduce its cost of capital and support the long-term growth of the partnership.

Regardless of the rationale behind these events, all of them had reverberations for an already fragile midstream market. To be sure, the reformation process has been frustratingly slow and difficult, and midstream management teams will need to continue working to restore credibility with investors. However, we believe the midstream sector is responding with positive change, which we believe creates a healthier set-up looking forward.

A Reflection on 2017

Looking back, we believe the most significant development in 2017 was the growing disaffection of equity investors with the oil and gas sector overall, including midstream energy. Equity investors who were burned by the crude oil-price decline that took prices from over $100/bbl in mid-2014 to $26/bbl in mid-February 2016 were dismayed by the resurgence in drilling activity once prices rebounded, fearing that activity levels would lead to a new oversupply in the global crude oil markets and another price decline would follow sooner than later.

Some investors expressed their weariness over the E&P companies' inability to control their spending by avoiding investments in the sector all together. Energy company equity offerings (and demand for such offerings) slowed substantially, particularly after the first quarter. Energy companies' weight in the S&P 500 Index fell to levels not seen since the early 2000s, according to our analysis of Bloomberg data.

Midstream energy companies were included in this general disaffection. Investor complaints over IDRs and complex capital structures got loud and grew louder. Concerns over the external financing model and its never ending equity raises grew as investors focused on the dilutive effect of equity issuance and the high costs of that capital. The high leverage levels and low distribution coverages that were previously acceptable became anathema. The increasing number of distribution cuts (by our count, 17 in total), regardless of the reason, only served to reinforce the negative sentiment and concerns in spite of the overall stability of sector business models. Additionally, the concerns over lack of discipline at the E&P level fell hard on midstream companies. The confusing idea that crude oil prices would continue in the $45-$50/bbl range because of too much U.S. production, yet MLPs would not be able to fill their pipelines because of too little volume, was a theme that pervaded much of the year.

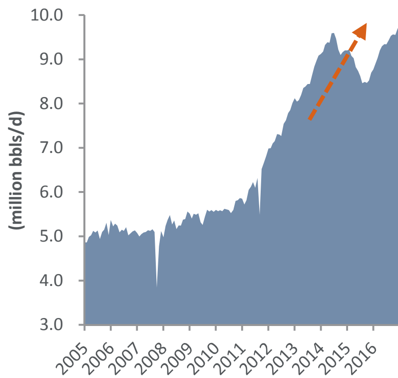
Did management teams get the message? It appears so, and while the transition has been painful the initial results appear promising. Many E&P managers announced drilling programs that are not forecasted to outspend their cash flows and management compensation schemes designed to reward return on capital, rather than production growth, regardless of real profitability.

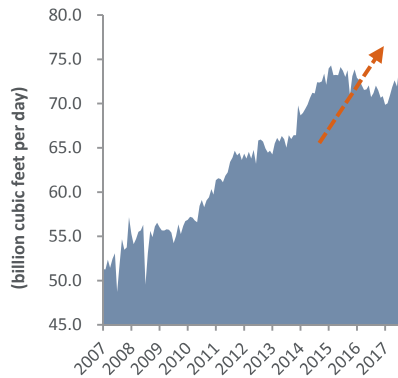
A number of midstream management teams began to move away from the external financing model and its repetitive equity raises to a more self-funded growth capitalization model. Sometimes, this took the form of actual distribution cuts. Sometimes, this included a lowering of the growth of future distribution increases. In almost all cases, management teams emphasized their focus on reducing leverage levels, reducing new equity issuance, and increasing distribution coverage.

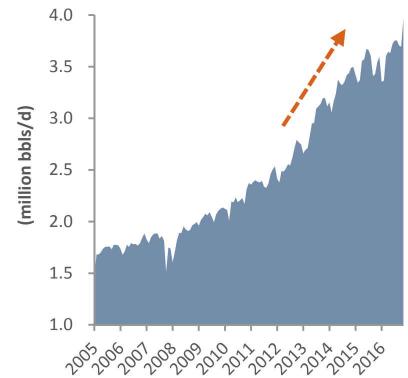
While we believe these steps can all be accretive to the overall equity value of a firm and could be the best prescription for the long-term, they were not met with universal acclaim. Yield-seeking investors were not generally pleased with either distribution cuts (regardless of purpose) or lower future distribution growth rates. "Retail fund flows," generally consisting of mutual funds, ETFs, and ETNs, were down from 2016 levels.

As discussed earlier, midstream management teams also recognized that the complexity of their capital structures were a detriment to new equity-linked capital raises, particularly from institutional investors. There was a significant response to the demand for simplification as many companies eliminated their general partner incentives.

The positive response of institutional investors, while less visible, is a positive "rest of the story." There continues to be growing interest and allocations from institutional investors to the midstream sector. While an anecdotal survey, it is clear that these investors are attracted by compelling valuations, the reduced need for dilutive equity issuances and a simplified capital structure – all combined with a positive fundamental energy backdrop.







1) *Source: Bloomberg and EIA. Data shown ranges from January 1, 2006 to December 31, 2017.*
2) *Source: Bloomberg and EIA. Data shown ranges from January 1, 2007 to December 31, 2017.*

Our 2018 Outlook

We are optimistic that midstream companies will generate attractive investment returns in 2018 and for the near future. We are also mindful that there are risks to this optimism. For those who have endured the performance of the last few years, their patience may finally be rewarded. And for those who are considering entry or re-entry into the sector, valuations appear to be very attractive both absolutely and relatively. Why are we optimistic?

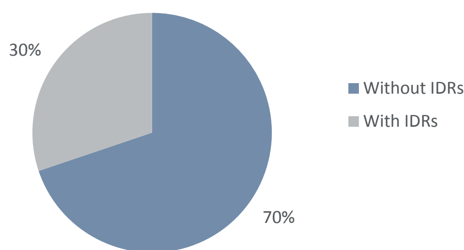
First, overall industry activity has rebounded and U.S. hydrocarbon production growth continues. As shown in the charts above, the U.S. is producing crude oil, natural gas and natural gas liquids at the historically highest levels. According to the U.S. Energy Information Administration ("EIA"), production growth is anticipated to occur well into the next decade. If the sector's business is the transport of oil and gas hydrocarbons, then the sector will likely have more business.

We believe much of the midstream industry "pain" has already taken place. 17 companies have reduced their distribution payouts, either by outright cuts or the "back-door" cuts that occurred during structural simplification. In our opinion there are less than a handful of companies remaining that need to or will consider these actions in the near term. We believe the worst of the damage is behind us.

Leverage ratios continued to decline during the period, perhaps not yet as quickly as some would like. But with many projects coming online in the next 12-18 months and contributing cash flow for the first time, it appears the pace of de-leveraging could quicken. And, many companies benefitted from low interest rates and the credit market recovery by issuing mid- and long-term debt at very attractive fixed rates.

While there is more work to do on structural capital simplification, a lot of that work has already occurred. By our count as of the end of 2017, over two thirds of the midstream market capitalization is no longer burdened by IDRs.

Midstream Market Cap by IDRs



Companies w/ Public Commitment to Self-Funding

Enterprise Products Partners, LP (NYSE: EPD)
Kinder Morgan Inc. (NYSE: KMI)
Magellan Midstream Partners, LP (NYSE: MMP)
MPLX, LP (NYSE: MPLX)
Williams Partners, LP (NYSE: WPZ)
Crestwood Equity Partners, LP (NYSE: CEQP)

1) *Source: Bloomberg and Cushing Asset Management.*

Many midstream companies are reducing their need for external financing. We note that not every company will be able to self-fund their organic growth; however, many of the biggest companies in the sector will not need to raise additional equity capital to fund their existing growth projects. With less equity issuance, we anticipate higher per unit earnings and cash flow growth going forward. This move to a more traditional corporate financing approach and a more sustainable opportunity is clearly preferred by institutional investors.

There are billions of dollars of projects anticipated to come online and into cash flow generation in 2018. The Marcellus/Utica area alone is projected to see $17 billion of pipeline projects coming into service in 2018, collectively capable of providing over 14 Bcf/day of new capacity. There are six committed projects in the Permian basin that, once online, could add over 1 million b/d of new capacity by the second half of 2019. Mariner East is anticipated to be put into service later in 2018, which should provide a new and significant source of NGL takeaway from the Northeast. The list goes on…

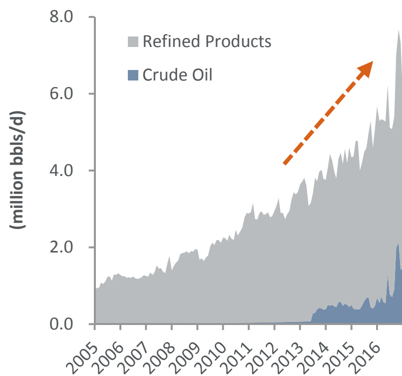
Export markets are booming. As shown in the charts below, we are at record levels of crude oil, refined products, natural gas, LNG, and NGL exports. Natural gas exports to Mexico could more than double over the next few years. As geopolitical risks increase (e.g. Middle East unrest, Venezuelan financial market collapse, growing unrest from Nigerian rebels, possible renewed sanctions on Iranian production, among others), many of the world's larger and/or emerging economies could choose to meet their energy needs from what they perceive as the most stable business economy that operates under the sanctity of contract law. Midstream companies provide the bulk of the transport and logistics services necessary to provide these exports.

With new restraint on the part of the E&P sector, and with new self-funding focus and simplified capital structures on the part of the midstream sector, we think there is a clearer path to sustainable growth for the energy sector. We will gladly trade a lower production growth trajectory for a more consistent and sustainable growth opportunity.

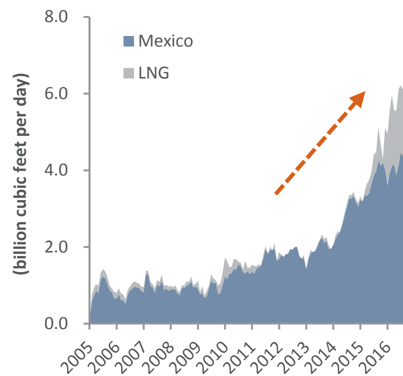
The uncertainty over the midstream industry's treatment in the new tax bill appears to have been favorably resolved. At the beginning of the negotiations, there were reasons to be concerned as it appeared that other asset classes, notably REITs, might receive more preferential treatment. At the end of the process, MLPs relative tax advantage to C-Corps was roughly maintained. And, the general energy tax changes clearly favor domestic activity over non-U.S. activity, which might push incremental E&P activity to the U.S.

For all the controversy over the political environment, the current Administration has generally been constructive on helping the oil & gas industry, midstream not excluded. The most obvious example was the turnaround in federal approval of the Dakota Access Pipeline and the support for the Keystone XL line earlier this year. The FERC is now fully staffed, and the FERC (which has four new Trump-era appointees) just unanimously rejected an attempt to prop up the coal industry to the detriment of the other electricity generating energy sources, of which natural gas is the largest constituent.

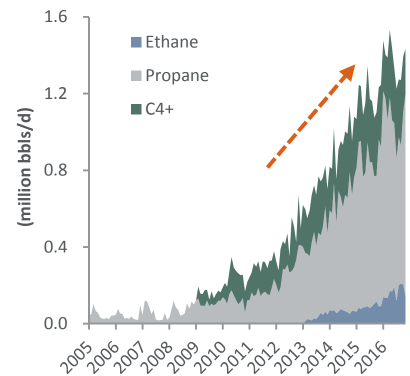
U.S. Crude Oil and Refined Products Exports



U.S. Natural Gas and LNG Exports



U.S. Natural Gas Liquid Exports



1) *Source: Bloomberg and EIA. Data shown ranges from January 1, 2006 to December 31, 2017.*

And despite all the noise about the next elections and who is running in 2020 – the current Administration still has at least three years of control over U.S. domestic energy policy. There is no sign of a near-term policy reversal coming, meaning the industry should have at least several years of good runway ahead.

Finally, valuations are attractive, as the metrics in the tables below show:

- Sector EV/EBITDA is trading at a discount to the S&P 500 Index for the first time since the 2008 financial crisis.
- Sector EV/EBITDA is trading at a discount to the 5- and 10-year averages, while utilities, E&P, oilfield services and other energy subsectors are trading above their respective averages.
- Valuation as measured by price/forward cash flow is trading over 2 times below the long-term average multiple; for comparison purposes, this multiple was nearly 3 time above the long-term average in the summer of 2014.
- Yield spreads remain persistently (some would say stubbornly) high compared to the other higher yield asset classes.

Current Versus Historical MLP Valuation Metrics

MLP Valuation Metrics	Current	5-Year Average	Premium (Discount)	10-Year Average	Premium (Discount)
Midstream MLP Yield	8.3%	7.0%	(16%)	7.2%	(14%)
Price-to-DCF	9.9x	12.0x	(18%)	12.1x	(19%)
EV-to-EBITDA	11.0x	13.7x	(20%)	12.8x	(14%)
Spread-to-10-Year Treasury – discount (premium)	591	475	--	422	--
Spread-to-Investment Grade Bonds – discount (premium)	413	216	--	165	--
Spread-to-High Yield Bonds – discount (premium)	294	112	--	(20)	--

Source: "Midstream Monthly Outlook: January 2018." Wells Fargo Securities. January 4, 2017.

Current Versus Historical Relative Valuation Metrics

EV-to-EBITDA Multiples	Current	5-Year Average	Premium (Discount)	10-Year Average	Premium (Discount)
MLPs	11.0x	13.7x	(20%)	12.8x	(14%)
Midstream C-Corps.	12.7x	15.1x	(16%)	13.5x	(6%)
Energy:					
Exploration and Production	8.7x	6.7x	30%	5.9x	47%
Refiners	8.2x	5.4x	52%	5.1x	61%
Integrated Exploration and Production	7.4x	5.3x	40%	4.8x	54%
Oilfield Services	9.2x	7.8x	17%	7.1x	30%
Yield:					
S&P 500 Utilities Index	10.1x	8.7x	16%	8.0x	26%
S&P 500 REITs Index	17.2x	16.6x	4%	15.1x	14%
Market:					
S&P 500 Index	11.3x	9.2x	23%	8.5x	32%

Source: "Midstream Monthly Outlook: January 2018." Wells Fargo Securities. January 4, 2017.

Key Risks to Our 2018 Outlook

We wrote at length throughout 2017 about our frustration with lagging group performance in the face of improving midstream fundamentals as the recovery phase of the energy cycle unfolded. We stated in the 2017 Third Quarter Midstream Energy Market Review:

> "*We remain convinced the underlying fundamentals for the midstream energy space have greatly improved since the cycle lows and continue to do so; however, investor sentiment (and resulting fund flows) remained stubbornly elusive. There was no shortage of investor grievances and concerns… however, we believe these factors have been overly discounted in current MLP valuations*."

However, while we and many midstream investors are optimistic that 2018 will bring attractive returns for the space (i.e. the "catch-up trade"), we caution that there remain risks to this outlook. To start, the record shows we were similarly optimistic at the beginning of 2017, and being 'long' midstream energy now seems to be a consensus trade, which can be a negative contrarian signal. Further, we doubt the litany of "*investor grievances and concerns*" will just magically disappear with the turning of the calendar. We have classified the key risks, including regulatory, competition, sentiment and commodities, below.

Regulatory Risk. While the Trump administration has clearly improved the regulatory environment at the federal level, there still remains fierce environmentalist opposition and state-level hurdles for large pipeline projects (e.g. Rover, Constitution, etc.). Unfortunately, there is no end in sight for this, and midstream management teams must budget accordingly, potentially including higher costs and longer timelines for new construction.

Additionally, with the newly passed tax law (lower corporate tax rates), there is increasing pressure for the industry to lower certain regulated cost-of-service pipeline tariffs which are calculated with a tax allowance. It is a complicated issue, and how and when the FERC addresses it remains uncertain. However, we do not expect a significant impact on the space given that a lower regulated max tariff would not impact negotiated rates or those already earning below the max rate. Nevertheless, this could weigh on the Natural Gas Transportation & Storage subsector.

Finally, we are monitoring ongoing petitions and filings regarding what's often referred to as the "Magellan Marketing Case." Put simply, Magellan has asked the FERC to "weigh in" on the legality of using a marketing business to subsidize an affiliated pipeline business. Stated another way, is it legal for a marketing segment to discount below a posted tariff rate (and deliberately incur a loss) in order to benefit and supply volumes to a pipeline segment, with the net result being an economic positive to the overall business? Or, are such transactions a violation of the Interstate Commerce Act? The Magellan Marketing Case has certainly ruffled the feathers of other midstream companies with marketing operations, and new regulations could be disruptive to current industry practices. Quoting from EPD's filed response, "*the marketing transactions described in the Magellan Petition are akin to basic arithmetic, while the real world activities of marketers are calculus.*" We doubt there will be any resolution to this issue in the near term; however, it could pose a risk to marketing affiliates and it is something we will continue to monitor.

Competition and Diminishing Returns. Most production growth and the opportunity for new infrastructure is in Tier 1 areas, most notably the Permian basin. With a laser focus on the Permian and a private equity sector that is flush with cheap capital, there is a concern that the industry will "compete-away" their returns for organic projects and/or acquisitions (i.e. "the winner's curse") and potentially overbuild. Given the large number of natural gas, crude, and NGL Permian takeaway projects already announced, this is a legitimate concern. Of course, time will tell, but MLP management teams are at least beginning to "talk the talk" in terms of capital discipline, a focus on per-share/unit metrics, and investor returns. As such, we do not expect all of these projects to be sanctioned and move forward. It should be noted that MLPs have passed on a couple of recent highly-priced private equity backed asset sales in the Permian.

For less attractive basins/assets, there are various under-utilized midstream systems with near-to-mid term contract expirations, and we will continue to monitor re-contracting risks—potentially leading to lower rates and volumes once contracts roll off. Two "front-burner" examples include Boardwalk Pipeline Partners LP (see its –12% performance since its October 2, 2017 contract restructuring announcement) and Tallgrass Energy Partners LP, which has one of the group's highest short interest ratios at 13.5 (see its December 28, 2017 contract restructuring announcement).

Investor Sentiment and Fund Flows. As previously discussed, retail fund flows were anemic in 2017, helping to drive weak MLP group performance. Retail investor sentiment was undoubtedly damaged—and maybe irreparably for some investors—due to various reasons including heightened volatility over a multi-year period, distribution cuts by certain blue chip names, and correlation to crude oil pricing (on the way down, but not so much on the way up). While "self-funding" is the new buzz phrase and some MLPs are already there or at least shifting that direction (this takes time), most MLPs still require a healthy, functioning equity capital market to fund growth initiatives. As of the date of this letter, January appears to be off to a good start, but this remains a risk.

Additionally and as discussed earlier, as more institutional investors stepped in to fill the retail investor funding void, the space faced cross-currents of investor preferences regarding leverage, coverage, corporate governance, and the GP/LP model. While the industry has made progress with these issues, it is still a dynamic environment with more transactions to come. For example, we are anticipating (at least) one more distribution cut as well as several simplification transactions; how investors react to a sizable distribution cut that improves leverage/coverage or to an IDR buyout at a particular multiple is a risk.

Commodity Markets. We believe the supply/demand dynamic for crude oil will continue to improve. As crude oil prices have stabilized at higher levels, we also believe investor sentiment and consequently energy sector valuations will continue to improve. Risks to our positive outlook include unexpected changes to the current OPEC supply agreement (such as an early exit) or other factors that could lead to a commodity price shock/collapse. If crude oil pricing continues to move higher, there is a risk that lower-beta MLPs could underperform oilfield services and E&P stocks.

Additionally, there is a great deal of investor and midstream industry focus and optimism based on the build-out of export-based infrastructure (or other infrastructure that "points to" export assets) of various commodities, including crude oil, refined products, natural gas, and LPGs. Export infrastructure is ultimately dependent on arbitrage economics or global markets that are able to absorb this supply over the long term, and this is a risk.

Concluding Remarks

After almost three years since the down cycle in energy began, we believe we are now fully into the recovery phase of the cycle. We think, in short, that the midstream environment will benefit from record levels of production from the U.S. coupled with record levels of demand for U.S.-sourced hydrocarbons. MLPs have continued to make headway in simplifying structures and eliminating IDR burdens. Companies have, in large part, responded to pressures from the market to improve balance sheets and distribution coverage and, we believe, are well positioned to take advantage of future growth opportunities. With the structural evolution of the asset class progressing, we expect the midstream sector to be more palatable to a wider group of investors.

Near term, with apparent tax-loss selling completed by year-end as well as passage of the "Tax Cuts and Jobs Act" (which maintained MLP's favorable tax status), two key risks/overhangs were removed for the MLP space. And, as if a switch was flipped with the start of the new year, retail fund flows (specifically related to open-end funds) have been nicely positive thus far in January.

We thank you for your support and your confidence in choosing Cushing Asset Management to manage your MLP investments. We are, as always, available to answer any questions you may have.

Cushing Investment Team

Important Disclosures

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Investments in MLPs are subject to price changes in crude oil and natural gas, as well as regulatory and interest rate risks, among others.

Glossary of Indices: The Alerian MLP Index (AMZ) is a composite of the most prominent energy master limited partnerships. The Cushing® 30 MLP Index (MLPX) is an equal weighted index that tracks the performance of 30 publicly traded MLP securities that hold midstream energy infrastructure assets in North America. The S&P 500 Index is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The S&P 500 Oil & Gas E&P Sub Industry Index (S5OILP) is a capitalization-weighted index. This is a GICS Level 4 Sub-Industry group. The Philadelphia Stock Exchange Oil Service Sector Index (OSX) is a price-weighted index composed of 15 companies that provide oil drilling and production services, oil field equipment, support services and geophysical/reservoir services. The S&P 500 Utilities Index is comprised of those companies included in the S&P 500 that are classified as members of the GICS utilities sector. The S&P 500 Real Estate Investment Trusts REITS Industry Index (S&P 500 REITS) is comprised of stocks in the S&P 500 Index that are classified as members of the GICS REITs sector.

Indices are included for comparative purposes only.

Certain information contained in this presentation may constitute "forward-looking" statements, which can be identified by the use of forward-looking terminology such as "may," "will," "should," expect," "estimate," or "believe" or other variations thereof. Due to various risks and uncertainties, actual events or results may differ materially from those reflected or contemplated in such forward-looking statements.

[1] Source: Bloomberg data compiled from U.S. Energy Information Administration ("EIA") reports including the "Weekly Petroleum Status Report" and the "Petroleum Supply Annual".