

The Problem In 1993, they entered a short position in the forward contract to sell oil products such as heating oil, and gasoline to customers, at a fixed price for up to 10 years. By December of that year, Metallgesellschaft had long positions in energy derivatives equivalent to 185 million barrels of oil. Their objective was that if oil prices fell, the hedge would lose money as the fixed-rate position would increase in value; if oil prices rose, the hedge gains would offset the losses on the fixed rate position. However, a problem with this strategy became evident as oil prices tumbled throughout 1993 in the aftermath of the war in Kuwait. The futures positions accounted for 55 million barrels and the swap positions accounted for 110 million barrels and these positions introduced credit risk for The Firm. (Wrong Hedging Ratio). The market turned from backwardation to contango