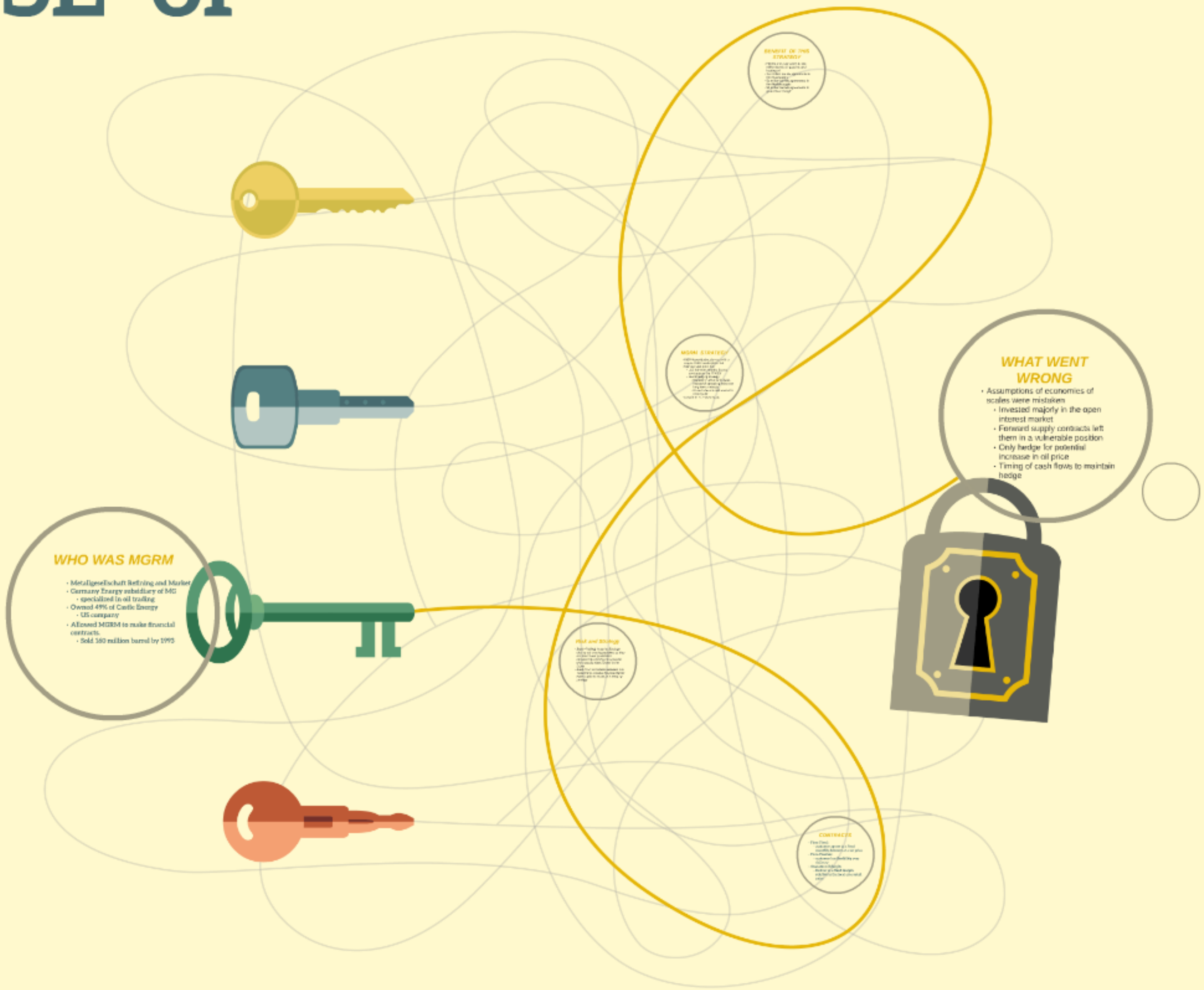
COLLAPSE of MGRM



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SAMANTHA JOHNSON
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AQUILES BOTTINI
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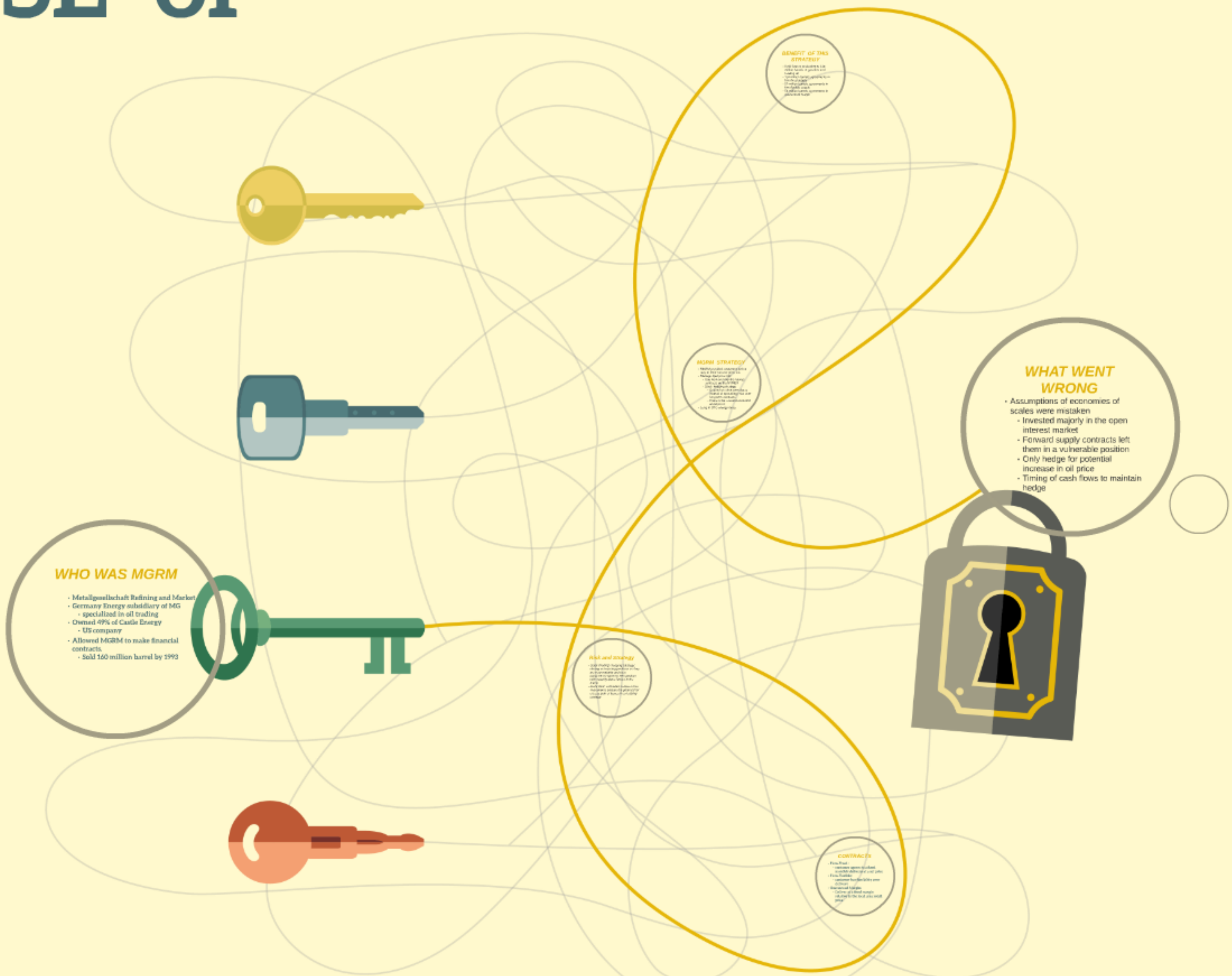

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WHO WAS MGRM

- Metallgesellschaft Refining and Market
- Germany Energy subsidiary of MG
  - specialized in oil trading
- Owned 49% of Castle Energy
  - US company
- Allowed MGRM to make financial contracts.
  - Sold 160 million barrel by 1993

Risk and Strategy

- *Stack (Rolling) Hedging Strategy: closing out existing positions as they are near maturity and then concurrently opening new position with maturity dates further in the future.*
- *Basis Risk: correlation between two investments creates the potential for excess gain or losses in a hedging strategy*

CONTRACTS

- Firm-Fixed :
  - customer agrees to a fixed monthly delivery at a set price
- Firm-Flexible:
  - customer has flexibility over delivery
- Guaranteed Margin:
  - Deliver at a fixed margin relative to the local area retail price

MGRM STRATEGY

- MGRM provided customers with a way to limit/ transfer price risk
- Manage spot price risk
  - Use front-end months futures contracts on the NYMEX
  - Stack hedging strategy
    - Depend on short term dates instead of spreading risks over long term contracts
    - Prove to be a sound economic stand point
- Long in OTC energy swap

BENEFIT OF THIS STRATEGY

- Held futures equivalent to 110 million barrels of gasoline and heating oil
- 102 million barrels agreements in firm fixed supply
- 52 million barrels agreements in firm flexible supply
- 54 million barrels agreements in guaranteed margin

WHAT WENT WRONG

- Assumptions of economies of scales were mistaken
  - Invested majorly in the open interest market
  - Forward supply contracts left them in a vulnerable position
  - Only hedge for potential increase in oil price
  - Timing of cash flows to maintain hedge