

Hedging: Hedging against price and currency risks in industrial procurement

Hedging refers to the protection against existing or future risks through targeted offsetting positions, typically relating to currencies, commodities or interest rates. In a procurement context, it serves to decouple price fluctuations from budgeted material costs and to avoid margin-eroding surprises. For industrial buyers, hedging is one element of risk management alongside contractual instruments such as price index linking or the price adjustment clause. The term comes from English and literally means "Hecke" (hedge) – i.e. a protective barrier against adverse developments.

Key facts

- Hedging protects prices or rates rather than speculating on rising prices; the goal is planning certainty, not profit maximisation.
- Typical instruments in procurement are forwards, options and swaps, as well as physical forward purchases and framework agreements.
- The most important use cases are currency risks in import purchasing and commodity prices such as steel, aluminium, copper or plastics.
- Hedging incurs costs, such as option premiums, spreads or haircuts on credit lines, and must therefore be assessed for economic viability.
- The most effective combination often consists of contractual protection (e.g. indexation) and financial hedging.
- Hedging generally follows a documented risk strategy; speculative positions have no place in a procurement context.

Definition: hedging

Hedging is the protection against an economic risk by building an offsetting position that compensates for any loss arising from an adverse development. In procurement, hedging is typically directed against currency fluctuations and price volatility in commodities or energy. The goal is not to speculate on price jumps, but to ensure the reliability of planned unit costs and margins.

Distinction from speculation

In hedging, the focus is on balancing an existing real-world transaction: anyone buying in USD from a USD supplier hedges the purchase rate because their cost position is at risk. Speculation, by contrast, deliberately bets on price movements without an underlying transaction. For procurement organisations the clear rule applies: only hedge risks that actually arise from procurement or sales, and assign every hedge to the underlying business transaction.

Why hedging is relevant for buyers

Material costs frequently represent the largest cost block in manufacturing industry. Unhedged currency

or commodity fluctuations can quickly render quotation calculations, framework prices and fixed-price business unprofitable, particularly with long lead times. Hedging creates budgeting certainty across the production and delivery cycle and protects orders offered at fixed prices with long terms.

Methods and approach to hedging

Hedging is not a one-off act but a structured process: identify and quantify risks, select instruments, define implementation and monitor continuously. The choice of instrument depends on risk duration, budget, balance sheet treatment and risk-bearing capacity.

Hedging currency risks

For import transactions in foreign currencies, forward foreign exchange contracts (forwards) are mainly used, guaranteeing a fixed future rate for a set date. Currency options protect against a maximum rate while leaving room to participate in favourable rates, but incur a premium. In practice, currency hedging often begins simply with invoicing in euros or price adjustment clauses in the contract before derivatives are used.

Hedging commodity and energy prices

Commodity risks can be covered via futures markets (futures, options), OTC contracts with banks or physical forward arrangements with suppliers. Often the route via the supplier is simpler: fixed-price agreements for defined volumes and periods, or dependence on the market price via price index linking. For metals such as copper or aluminium, exchange-traded contracts are established; for plastics or speciality products, hedging is often only possible indirectly via commodity proxy indices.

Contractual protection as a complement

Hedging does not replace contract management. Price adjustment clauses, indexation, option volumes and defined price adjustment mechanisms distribute risks contractually between buyer and supplier. Especially for long projects and ramp-down management at end of product life, clear pricing rules are often more effective than purely financial hedging. The two approaches complement each other: the contract defines the risk allocation, while hedging smooths remaining fluctuations.

Key KPIs and assessment measures in hedging

The success of hedging cannot be measured by the pure financial result of the derivatives alone, but only in combination with the underlying business being hedged. Meaningful metrics therefore take both hedging effect and costs into account.

Hedge ratio and coverage

The hedge ratio indicates what proportion of plannable demand is covered by hedging transactions. Depending on their risk policy, companies typically hedge between 50 and 100 per cent of rolling demand, often staggered over several quarters. It is important that the hedged demand mirrors real procurement planning and replenishment processes, otherwise superfluous or missing positions arise.

Effective purchase price versus market price

The key assessment measure is the effective purchase price after hedging compared with the pure market price. This difference shows the cost of the hedge, such as option premiums or bank margins. Supplementary metrics such as the volatility of effectively incurred material costs or the plan variance of

budgeted prices provide insight into the effectiveness of the strategy.

Costs and benefits

Hedging is not free of charge: premiums, spreads, margin deposits and internal process costs must be taken into account. A process cost analysis can determine whether financial hedging is worthwhile for a particular material segment at all, or whether contractual instruments such as fixed-price agreements offer the same degree of security more cheaply.

Risks and controls in hedging

Hedging reduces market risks but creates risks of its own: liquidity strain, counterparty risk, accounting complexity and behavioural risks arising from misunderstood instruments. Without clear governance, hedging can unintentionally turn into speculation.

Governance and risk strategy

Successful hedging programmes are based on a written risk strategy with clear targets, permitted instruments, limits and responsibilities. Procurement, Treasury and Controlling must be closely interlinked so that hedges match real demand. Every position should be documented and regularly reconciled against the underlying business.

Basis risk and volume risk

Hedging rarely eliminates price risks completely. Basis risk arises when the hedging instrument does not exactly match the product actually procured – for example, when a metal contract does not reflect the surcharge for a special alloy. Volume risk occurs when actual demand deviates from planning, for instance in the event of short-notice ramp-downs or changed offtake criteria. Residual risks should be documented and captured contractually in price adjustment clauses.

Counterparty risk and legal framework

Derivative transactions depend on the solvency of the counterparty; their creditworthiness is part of the risk. Legally, permissible instruments, accounting treatment (hedge accounting) and regulatory obligations for derivative transactions must be observed – in individual cases this should be examined from a tax, accounting and legal perspective. International aspects such as customs clearance, Incoterms FOB or Incoterms CIF also influence which portion of the price needs to be hedged at all.

Current developments: digitalisation and hedging in procurement

Digital procurement and analytics tools are changing hedging too: better data quality, automated price indices and AI-supported forecasts improve the basis for decision-making. At the same time, volatility and geopolitical risk are rising, which makes hedging strategies more important.

Data-driven hedging decisions

Modern e-procurement systems and invoice automation provide more accurate and more timely demand and cost data – the foundation for sound hedging volumes. Approaches using AI in procurement help forecast demand development and price indices, for example for steel or plastics markets. This allows the hedging period to be chosen more realistically and over-hedging to be avoided.

Volatility and geopolitical uncertainty

Sanctions, trade conflicts, energy discontinuities and supply chain disruptions have increased price volatility for many industrial commodities in recent years. Geopolitical risk cannot be fully hedged – it requires complementary measures such as qualifying additional suppliers, flexibility in small-series production and clear complaint and quality agreements when changing suppliers. Price index linking and transparent market data provide the additional counterbalance here.

Link to procurement strategy

Hedging works best as part of a holistic procurement strategy: order and demand planning, the supplier portfolio, contract design and hedging must interlock. Those with multiple sourcing options, flexible volume models and transparent pricing arrangements can deploy hedging more specifically and cost-effectively. Certifications such as AEO status or sustainability credentials such as FSC/PEFC certification also influence which supplier and pricing strategies are viable in the first place.

Typical metrics

Hedge ratio: typically 50–100 % of plannable demand

depending on risk policy, often staggered over several quarters

Effective purchase price vs. market price: keep deviation as low as possible

shows the cost of hedging, e.g. premiums and margins

Material cost variance against plan: in practice often < 5 %

measures how well budgeted prices are stabilised through hedging

Volatility of effectively incurred costs: significantly lower than unhedged market price volatility

target measure of hedging effectiveness

Practical example

A medium-sized machinery manufacturer sources components and semi-finished products partly in USD and uses copper and aluminium profiles in significant volumes. After a year marked by strong exchange rate and commodity fluctuations, it repeatedly suffered margin losses on fixed-price projects. The company subsequently established a structured hedging process in cooperation with Treasury and Procurement.

- Introduction of a rolling hedging strategy: 60–80 per cent of plannable USD demand via forward foreign exchange contracts, the remainder left open.
- Conversion of critical commodity positions to contracts with price index linking and defined adjustment mechanisms instead of rigid fixed prices.
- Monthly alignment meeting between Procurement, Controlling and Treasury to reconcile hedging volumes with actual demand planning.
- Documented risk strategy with limits, responsibilities and reporting to management.

Conclusion

Hedging is an important instrument for industrial buyers to make currency and commodity risks manageable and to keep calculations reliable across long delivery cycles. It is no substitute for sound contracts or good supplier strategies, but complements them with financial planning certainty. What matters is a documented risk strategy, clean alignment between Procurement, Treasury and Controlling,

and realistic demand data. Those who understand hedging as part of an integrated risk management approach reduce volatility in material costs – without drifting into speculation. In individual cases, legal, accounting and tax questions should always be reviewed by qualified experts.

Frequently asked questions

What does hedging mean in procurement?

Hedging in procurement means hedging against price and currency risks arising from purchasing transactions. Typical examples include hedging USD purchases via forward foreign exchange contracts or hedging metal prices via futures contracts. The objective is budgeting certainty, not speculation on price movements.

Which hedging instruments are relevant for buyers?

Commonly used instruments include forward foreign exchange contracts, currency options, commodity futures, swaps and OTC contracts with banks. In addition, there are physical hedges such as forward purchases, framework agreements with fixed prices, or contractual price adjustment clauses and price index linking. The choice depends on risk duration, budget and risk policy.

What does hedging cost?

Hedging typically incurs costs in the form of option premiums, bank margins, spreads, margin deposits and internal administrative effort. Forward contracts usually involve no explicit premium at conclusion, but they do lock in the rate. Whether the hedge is worthwhile should be assessed by comparing the effective purchase price with the market price.

What percentage of demand should be hedged?

There is no fixed value for this; depending on their risk policy, companies frequently hedge between 50 and 100 per cent of plannable demand, often staggered over several months. What matters is that the hedged volume is aligned with real demand planning and replenishment data. A documented risk strategy with limits is a prerequisite.

What is the difference between hedging and speculation?

With hedging, the offsetting position serves to balance a real business risk, such as a foreign currency purchase or commodity requirement. Speculation deliberately bets on price movements to make a profit without an underlying transaction. In procurement, every hedge should always be assigned to and documented against a specific purchasing transaction.

Can commodity prices such as steel or plastics be hedged?

For standardised metals such as copper, aluminium or steel, established futures and options markets exist. For plastics, special alloys or components, direct hedging is often difficult; in such cases proxy indices, physical forward purchases or contractual instruments such as price index linking come into play. Residual risks from basis and volume deviations generally remain.