



EXECUTIVE BRIEF

Inflation Collars in Infrastructure: Bounded Protection for CPI-Linked Revenue

Mike Duncan | Para Bellum Advisors

mike.duncan@parabellumadvisors.com | www.parabellumadvisors.com

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Executive Summary

Infrastructure investors and regulated asset operators frequently assume that CPI-linked revenues provide genuine inflation protection. They do not, once fixed-rate debt and the timing of the next regulatory reset are factored in.

The trap is structural. Revenues escalate with CPI under regulatory building blocks. Debt costs are fixed because the capital structure was locked in during low-rate years. The asset appears to benefit from high inflation: coverage improves and cashflow rises. Then the regulator claws it back in the next determination by resetting allowed returns and normalising what it sees as an inflation windfall.

High inflation is a deferred liability, not a benefit.

This brief sets out a practical hedge overlay for managing this risk: a bounded inflation collar with annual reset, and an optional contingent forward-starting component aligned to the next regulatory determination.

The Structural Problem Infrastructure Keeps Missing

In regulated infrastructure, revenues and regulated asset base metrics adjust with CPI while debt costs do not, where the debt stack is fixed-rate bonds issued during the 2016 to 2019 low-rate window. Inflation spikes create a short-term uplift in cashflow and coverage ratios. Boards and investors typically interpret this as an earnings tailwind.

Regulators notice the same uplift. In the next determination, they reset allowed returns using current market conditions and normalise what they view as inflation-driven over-earnings. The real risk is not that inflation hurts cashflows today. It is that inflation creates cashflow today that becomes a regulatory haircut tomorrow.

That is a hedgeable exposure. But only if the structure matches how the regulatory mechanics actually land.

Why Vanilla Approaches Fail

Alternative	Why it looks right	Where it breaks down
Vanilla inflation swap	Direct CPI exposure; simple hedge accounting	Pays for moderate outcomes that need no protection; settles on cumulative logic misaligned to annual regulatory mechanics
Inflation-linked debt issuance	Creates natural hedge; debt service rises with CPI	Cannot refinance existing fixed-rate bonds without crystallising MTM losses; does not address deferred reset risk
Do nothing	No execution costs; operationally simple	High-inflation clawback is unmitigated; not a defensible position once the risk is quantified

The Practical Answer: A Bounded Inflation Collar

A collar is bounded protection. Buy protection above a high strike, a cap on inflation. Fund it by selling protection below a low strike, a floor on inflation. Between the strikes, the hedge does nothing. That is intentional.

The design philosophy keeps natural exposure where it is tolerable and insures only the tails. Buy an inflation cap: protection if CPI prints above the cap strike. Sell an inflation floor: payment obligation if CPI prints below the floor strike. Select strikes so that the premium received from selling the floor broadly funds the cap premium, targeting zero or near-zero net cost at inception.

The trade being made explicit: protection against a likely bad outcome in exchange for exposure to a lower-probability one. That trade is rational if the downside state is genuinely remote relative to the business.

Annual Reset vs Cumulative Settlement

This is one of the most consequential design decisions. A cumulative collar pays on accumulated inflation since inception. The problem is that the underlying exposure is not cumulative CPI. It is the annual interaction between CPI and the regulatory building blocks. Each year's inflation reading independently influences allowed returns. A cumulative structure creates tracking error against the actual risk.

An annual reset treats each year independently. If inflation prints above the cap strike in 2024, there is a payout for 2024. The counter resets. This improves hedge effectiveness for regulatory outcomes. One-year tenors align CPI fixing conventions and avoid compounding basis between annual resets.

Year-by-Year Scenario Analysis

Scenario	CPI outcome	Net effect on asset
A: High inflation	Averages 5%+ per year	Cap triggers; annual payouts received. Clawback exposure offset.
B: Moderate inflation	3% to 4% per year	Inside the band; no payment either way. No unnecessary premium paid.
C: Low inflation	Below 2% floor	Floor triggers; utility pays out. Accepted trade-off.

Scenario B is the most important: the collar doing nothing in the middle range is not a failure. It is the design working correctly.

The Contingent Forward-Starting Component

The real economic impact often materialises in the next determination period, not the current one. Paying now for protection against a future event that may not crystallise is expensive and inefficient.

A forward-starting collar for the subsequent regulatory period activates only if the risk actually materialises. If the next determination includes a CPI-related clawback above a defined threshold, a second collar becomes effective. If it does not, the forward component expires with no premium loss beyond what was paid for the option to activate. This follows the same logic as contingent forwards in cross-border M&A: do not pay for protection unless the trigger event occurs.

Implementation: Where These Structures Actually Fail

These structures do not fail because the mathematics is hard. They fail because the institution cannot execute through its stakeholders.

Stakeholder	The friction and how to address it
Regulator	If revenues are CPI-linked, why hedge inflation? The correct response: this hedge addresses the mismatch between CPI-linked revenues and fixed liabilities across regulatory resets, not CPI exposure per se.
Auditor	Can you hedge an outcome dependent on a future regulatory determination? You can, if the exposure is highly probable and effectiveness testing is robust. Specialist hedge accounting input is worth the cost.
Bank counterparty	Forward-starting and contingent components attract complexity premiums. Competitive bids and willingness to walk away are the only effective responses.
Board and CFO	CSA collateral posting is often misread as the hedge failing. It is the hedge working in the scenario it was built for. Clear governance documentation from the outset removes this ambiguity.

Execution success is mostly stakeholder management. The analytical work is usually the smaller part.

Where This Structure Applies

This is not a niche solution. It is applicable wherever CPI-linked regulated or contracted revenues exist alongside fixed-rate debt locked in during a low-rate period, with a reset mechanism such as a regulatory determination or concession reset creating a meaningful gap between today's cashflow benefit and tomorrow's reset haircut.

In practice that describes most regulated infrastructure: water, energy networks, gas distribution, toll roads, ports, and airport aeronautical tariffs all share variants of this structure.

About This Brief

This Executive Brief is a companion to the Para Bellum Advisors practitioner paper: Inflation Collars in Infrastructure: Structured Protection for CPI-Linked Revenue with Fixed-Rate Debt.

Available at www.parabellumadvisors.com/insights/

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The firm focuses on hedge framework design, overlay mechanics, collateral efficiency, and portfolio resilience across FX, rates, credit, equity, and volatility exposures. Its work is practitioner-led, drawing on three decades of experience across trading, structuring, and portfolio management in APAC and globally.

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www.parabellumadvisors.com | mike.duncan@parabellumadvisors.com

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