BILATERAL FORWARD CONTRACTS AND SPOT PRICES IN THE ELECTRICITY MARKETS

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Abstract

Allaz and Vila (1993) have shown that forward markets could be an effective tool to mitigate market power and improve efficiency. This paper demonstrates that the Allaz and Vila result is sensitive to the assumption of organized forward markets with players behaving like rational expectations agents when forecasting prices. The paper also finds that the existence of forward contracts increases spot prices and hurts efficiency when buyers engage in bilateral forward contracts at historic prices. These findings have important policy implications for electricity industry.