Pricing twice the cost? The Impact of Forward Contracts on the Pass-Through of Emissions Allowance Prices - Empirical Evidence from the Spanish Electricity Market

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Abstract

Forward contracts are known to increase competition in oligopoly. A firm that has hedged forward is willing to sell the hedged quantity at marginal costs in the spot market. When firms compete in supply functions, however, they will sell with a positive (negative) mark-up on marginal costs any quantity larger (smaller) than the hedged volume. A cost shock will therefore lead to mark-up adjustments varying along the supply curve, which translates into a varying rate of cost-pass-through. Building upon the analysis of Fabra and Reguant (AER, 2014) we are able to show this varying rate of pass-through for CO_2 costs at hand of microdata from the spanish electricity wholesale market. It has important implications for the analysis of market power, competition and regulation of electricity wholesale markets in general.