A two stage stochastic equilibrium model for electricity markets with two way contracts

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Abstract This paper investigates generators’ strategic behaviors in contract signing in the forward market and power transaction in the electricity spot market. A stochastic equilibrium program with equilibrium constraints (SEPEC) model is proposed to characterize the interaction of generators’ competition in the two markets. The model is an extension of a similar model proposed by Gans et al. (Aust J Manage 23:83–96, 1998) for a duopoly market to an oligopoly market. The main results of the paper concern the structure of a Nash–Cournot equilibrium in the forward-spot market: first, we develop a result on the existence and uniqueness of the equilibrium in the spot market for every demand scenario. Then, we show the monotonicity and convexity of each generator’s dispatch quantity in the spot equilibrium by taking it as a function of the forward contracts. Finally, we establish some sufficient conditions for the existence of a local and global Nash equilibrium in the forward-spot markets. Numerical experiments are carried out to illustrate how the proposed SEPEC model can be used to analyze interactions of the markets.

Keywords Electricity market · Nash equilibrium · Stochastic equilibrium programs with equilibrium constraints

1 Introduction

Over the past two decades, the electricity industry in many countries has been deregulated. One of the main consequences of deregulation is that the governments under-
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take their efforts to develop fully competitive electricity spot markets. In most of the wholesale spot markets (pool-type systems), generators make daily (or hourly) bids of generation at different prices, and then an independent system operator (ISO) decides how actual demand is to be met by dispatching cheaper power first. In these pool-type electricity markets (found in Australia, New Zealand, Norway, at one time in UK, and some parts of US), a single market clearing price is determined by a sealed-bid auction and paid to each generator for all the power they dispatch.

Along with the spot market emerges the forward market where generators and retailers may enter into hedge contracts before bidding in the spot market. For example, in the early 1990s, during the restructuring of the electricity market in UK, some long term, “take-or-pay” contracts (or agreements) are stipulated by three main Scottish electricity generators, see Onofri (2005). Moreover, various contract markets have also been established in Europe, Australia, New Zealand and North America. By participating in the forward markets, generators and retailers may share their risks associated with a fluctuating pool price for the real power dispatching. The most common type of contract is known as a (two-way) contract-for-difference (or hedge contract), which operates between a retailer and a generator for a given amount of power at a given strike price. The signing of this type of contracts is separate from the market dispatching mechanism and can be taken as financial instruments without an actual transfer of power.

In this paper, we formulate generators’ competition in the forward-spot market mathematically as a two stage stochastic equilibrium problem where each generator first aims at maximizing its expected profit by signing a certain mount of long term contracts and then bids for dispatches in the spot market on a daily or hourly basis. Differing from the two stage competition model, a volume of previous research has been performed to study the effect on the competition in the spot market from the contract quantities, in which the competition of signing contracts in the forward market is not considered. von der Fehr and Harbord (1992) investigate the spot market by modeling it as a multi-unit auction and demonstrate that contracts give generators a strategic advantage in the spot market by allowing them to commit to dispatch greater quantities during peak demand periods. Powell (1993) explores the interaction between the forward market and the spot market by characterizing the competition in the spot market within a framework of Nash–Cournot equilibrium, and shows that risk-neutral generators can raise their profits by selling contracts for more than the expected spot price. Moreover, Green and Newbery (1992) appropriately look at the endogenous formation of both pool and contract prices in a supply function model, and apply their analysis to the British electricity market.

By modeling the mechanism of the competition in the forward market as a Nash–Cournot game, previous contributions, such as (Allaz and Vila 1993; Willems 2005; Gans et al. 1998), focus on the impact of the forward market on the spot price and show that generators have incentives to trade in the forward market whereas forward contracting reduces spot prices and increases consumption levels. The exploration of the bilevel deterministic Nash–Cournot model for a duopoly forward-spot market is first carried out by Allaz and Vila (1993), which identifies two critical assumptions: One is the so-called Cournot behavior where producers (generators) act as though the quantity offered by the other competitors is fixed; the other is the connection to the
prisoner’s dilemma where each producer (generator) will sell forward so as to make them worse off and make consumers better off than would be in the case if the forward market did not exist. Applying this type of Nash–Cournot models of electricity pools, Gans et al. (1998) demonstrate that the contract market can make the duopolistic spot market more competitive, and hence the existence of the contract market lowers prices in pool markets. By replacing two way contracts with call options, Willems (2005) extends the results in Allaz and Vila (1993) to the Cournot type market with options, and compares it with the market efficiency effects of the Cournot game with two way contracts. Instead of duopoly markets in Allaz and Vila (1993), Bushnell (2007) presents some estimation of the impact of forward contracts and load obligations on spot market prices for a Cournot type environment with multiple generators.

Differing from much of previous work concerning on the influence on spot market efficiency from contracts, our work provides a new model for the entire forward-spot market by formulating it as a two stage stochastic equilibrium problem with equilibrium constraints (EPEC), which refers to generators’ competition in the forward market as an equilibrium problem subject to the equilibrium in the spot market described by a complementarity problem. Over the past few years, EPEC models have been applied to some hierarchical decision-making problems in a wide domain in engineering design, management, and economics. Recently, a number of EPEC models have been performed for electricity markets. In modeling the forward-spot market, Su (2007) and Shanbhag (2005, Chapter 5) study the Nash–Cournot equilibrium by modeling the bilevel markets as an EPEC. Su (2007) investigates the existence results for the deterministic forward-spot market equilibrium introduced by Allaz and Vila (1993). Shanbhag (2005, Chapter 5) introduces a 2-node forward-spot model and considers it as an expected profit maximization problem subject to the complementarity constraints for every scenario in the spot market. He also investigates existence of the simultaneous stochastic Nash equilibrium (SSNE) in the context of the forward-spot electricity market. Moreover, besides the application in the forward-spot market, the EPEC models are also used by Yao et al. (2007) to investigate the equilibrium in the spatial electricity market, where they capture the congestion effects and bilevel competitions by formulating each generator’s objective as a maximization problem in the forward market subject to the Karush–Kuhn–Tucker (KKT) optimal conditions in the spot market and the network constraints. More recently, Hu and Ralph (2007) use EPEC to model a bilevel electricity market, where generators and customers bid cost and utility functions in a nodal market and the ISO determines the dispatch quantities by minimizing the overall social cost in an upper optimization level.

Apart from Cournot-type models, another well established approach is the supply function equilibrium (SFE) model, which clearly encapsulates the underlying structure of bidders’ strategy on the quantity–price relationship. SFE is originally proposed by Klemperer and Meyer (1989) to model competition in a general oligopolistic market where the market demand is uncertain and each firm aims to develop a supply function to maximize its profit in any demand scenario. By applying the SFE to predict the performance of the pioneer England and Wales market, Green and Newbery (1992) analyze the behavior of the duopoly and characterize the England and Wales electricity market during its first years of operation under the SFE approach. Anderson and Philpott (2002) first propose an optimal supply function model with discontinuous
supply functions to address the fact that supply functions in practice are not continuous as assumed in SFE model and they use this model to investigate generators’ optimal strategies of bidding a stack of price–quantity offers into electricity markets in circumstances where demand is unknown in advance. Anderson and Xu (2005) extend the optimal supply function approach to consider both second order necessary conditions and sufficient conditions of the optimality for each generator’s price-quantity offers given its rivals’ offers are fixed. Besides the analysis on the optimality conditions for the spot market, the SFE framework has also been applied to investigate the interactions between the forward market and the spot market. Green (1999) and Newbery (1998) are among the first researchers who study the impact of two-way contracts in conjunction with the SFE model and observe that contracts provide incentives for generators to supply more in a spot market. Anderson and Xu (2006) make further investigations in this direction by considering the optimal supply functions in electricity markets with option contracts and nonsmooth costs. However, calculating an SFE requires solving a set of differential equations instead of the typical set of algebraic equations as in Cournot models, which presents considerable limitations on the equilibrium conditions and the numerical tractability. Indeed, the existence of the SFE has been proved only for linear supply function models (Rudkevich 2005) and for symmetric models without capacity limit (Klemperer and Meyer 1989), with capacity constraints (Anderson and Xu 2005; Holmberg 2008), and there is no discussion about an SFE model for a two stage forward-spot market.

Along the direction of the research on EPEC and Cournot models, this paper makes a number of contributions. First, we present mathematical models for generator’s optimal decisions and Nash–Cournot equilibrium problems in the forward-spot market. Second, we discuss the existence and uniqueness of Nash–Cournot equilibrium in the spot market and investigate properties of such equilibrium. Third, we show the existence of Nash–Cournot equilibrium in the forward market.

The rest of the paper is laid out as follows: in the next section, we give a detailed description of an SEPEC model for the forward-spot market competition, and show that the equilibrium in the spot market depends on the contract quantities rather than the strike price. In Sect. 3, we use a complementary program model to solve the equilibrium problem in the spot market, and obtain the existence and uniqueness results and the monotonicity of the supply functions with respect to the contract quantities. In Sect. 4, we show the existence of Nash–Cournot equilibrium of the forward-spot market interaction, and the continuity of each generator’s profit in the forward market. In Sect. 5, we present some numerical tests to illustrate the theoretical results in this paper. Finally, in Sect. 6, we point out the restrictions of the paper and further work.

2 Mathematical description of the problem

In this section, we present mathematical details on modeling competition in the forward market and the spot market, and show that the optimization problem in the forward-spot market can be structured as a two stage stochastic equilibrium model. This model can be viewed as an extension of a similar model by Gans et al. (1998) in a duopoly to an oligopoly.
We suppose that there are $M$ generators competing in a non-collaborative manner for dispatch in the spot market on daily basis and these generators are economically rational and risk neutral. In the spot market, market demand is characterized by an inverse demand function $p(Q, \xi(\omega))$, where $p(Q, \xi)$ is the spot price, $Q$ is the aggregate dispatch quantity and $\xi(\omega)$ is a random shock. Here, $\xi : \Omega \rightarrow \mathbb{R}$ is a continuous random variable defined on probability space $(\Omega, \mathcal{F}, P)$ with known distribution. To ease the notation, we will write $\xi(\omega)$ as $\xi$ and the context will make it clear when $\xi$ should be interpreted as a deterministic vector. We denote by $\rho(\xi)$ the density function of the random shock and assume that $\rho$ is well defined and has a support set $\Xi$.

Since the outcome of the clearing price $p(Q, \xi)$ is fluctuating in the spot market, both generators and retailers wishing to ensure a fixed or a stable electricity price to hedge the risks rising from the variation of the spot price can do so by signing forward electricity contracts. This kind of contracts can be taken as a financial instrument and does not involve actual transaction of power. There are essentially two types of contracts: a one-way contract such as a put option or a call option where only one side of the contract commits to pay the difference between the strike price and the spot price for the contracted quantity, and a two-way contract where both sides of the contracts commit to pay the prices difference as opposed to the one way contract. In this paper, we simplify the discussion by focusing on two-way contract, that is, each generator signs a two-way contract with retailers.

### 2.1 Generator’s optimal decision problem in the spot market

We begin the model of the spot market by formulating a generator’s profit function which involves three terms: a revenue from selling electricity in the spot market, the cost of generating the electricity and the difference due to the commitment to a contract.

First, we look into the term of each generator’s commitment to its contract by giving details on the contract signing and the mechanism of generators’ fulfillment in the spot market. We assume that, in the forward market, generator $i, i = 1, \ldots, M$, enters into a two-way contract at a fixed price $z_i(x_i, x_{-i})$ for an amount $x_i$, where $x_{-i} := (x_1, \ldots, x_{i-1}, x_{i+1}, \ldots, x_M)^T$ denotes the vector of contract quantities signed by its rivals and the superscript $T$ denotes transpose. Here $z_i$ is a function of $x_i$ and $x_{-i}$. For the simplicity of notation, we write $z_i(x_i, x_{-i})$ as $z_i(x)$, where $x := (x_1, \ldots, x_M)^T$. We will come back to investigate the property of function $z_i$ later on. Taking all forward contracts as financial instruments, we may regard the fulfillment of these contracts equally as generators’ commitment to daily power supply over a certain time period. Under such contracts, generator $i$ gets paid $x_i(p(Q, \xi) - z_i(x))$ from the other party of the contract when the market clearing price $p(Q, \xi)$ is greater than $z_i(x)$ and pays the other party by $x_i(z_i(x) - p(Q, \xi))$ otherwise.

Consider a spot market in which generators set their dispatch quantities before the realization of the market demand uncertainties. If generator $i$’s dispatch quantity is $q_i$ and the aggregate dispatch from its rivals is $Q_{-i}$, then at a demand scenario $p(\cdot, \xi)$, the market is cleared at the price $p(q_i + Q_{-i}, \xi)$ and each generator is paid at the price for their dispatch. Hence, we can formulate generator $i$’s revenue from selling...
electricity \( q_i \) by \( q_i p(q_i + Q_{-i}, \xi) \). Note that in this model, a generator can influence the market clearing price and hence its revenue by choosing a proper \( q_i \). In reality, some markets allow generators to bid in a stack of quantities at an increasing order of prices for dispatch and the ISO forms a schedule of aggregate quantities at each price by putting them together. After the realization of the demand shock, the market clearing price is determined and all bids below the price get dispatched which are paid at the same price, see for instance Anderson and Philpott (2002) and references therein. Our work simplifies the bidding and clearing mechanism in the real market by looking at a generator’s total dispatch/supply and aiming to capture some insights on how a generator plays its strategy to influence the spot market by adjusting its total supply of power, which is a Cournot model.

Finally, we assume that generation of an amount \( q_i \) by generator \( i \) incurs a total cost of \( c_i(q_i) \), which is twice continuously differentiable for any \( q_i \geq 0, i = 1, 2, \ldots, M \). Accordingly, generator \( i \)’s profit in the spot market is

\[
R_i(q_i, x, Q_{-i}, \xi) := q_i p(q_i + Q_{-i}, \xi) - c_i(q_i) - x_i p(q_i + Q_{-i}, \xi) - z_i(x).
\]

Therefore, generator \( i \)'s decision problem is to choose \( q_i \) to maximize \( R_i(q_i, x, Q_{-i}, \xi) \), where \( x, \xi, Q_{-i} \) and \( z_i(x) \) treated as fixed parameters, that is,

\[
\max_{q_i \geq 0} R_i(q_i, x, Q_{-i}, \xi) := q_i p(q_i + Q_{-i}, \xi) - c_i(q_i) - x_i p(q_i + Q_{-i}, \xi) + x_i z_i(x).
\]  

(2.1)

In the following, we state two assumptions on each generator’s implicit capacity limit, the differentiability of \( p(\cdot, \xi) \) for \( \xi \in \Xi \) and \( c_i(\cdot) \) for \( i = 1, 2, \ldots, M \). We first make the following assumption on generators’ capacity limits.

**Assumption 2.1** For each generator \( i, i = 1, 2, \ldots, M \), there is a capacity limit \( q_i^u \), such that

\[
c'_i(q_i) \geq p(q_i, \xi), \quad \text{for} \quad q_i \geq q_i^u, \quad \xi \in \Xi.
\]

Observe that, Assumption 2.1 is an implicit way of ensuring that each generator’s dispatch quantity is upper bounded. This type of assumptions has been used by Sherali et al. (1983); DeWolf and Smeers (1997) in a deterministic version, and by DeMiguel and Xu (2008) in a stochastic version, for the same purpose. The assumption implies that even generator \( i \) was a monopoly, its marginal cost at output level \( q_i^u \) or above would exceed any possible market price. Therefore, none of the firms would wish to supply more than \( q_i^u \). Moreover, we proceed to make some fairly standard assumptions on the inverse demand function and generators’ cost functions.

**Assumption 2.2** For \( Q \geq 0 \) and \( q_i \geq 0, i = 1, 2, \ldots, M \), the inverse demand function \( p(Q, \xi) \) and the cost function \( c_i(q_i) \) satisfy the following:

(a) \( p(Q, \xi) \) is twice continuously differentiable w.r.t. \( Q \), and \( p(Q, \xi) \) is a strictly decreasing and convex function of \( Q \) for every fixed \( \xi \in \Xi \).
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(b) \( p'_Q(Q, \xi) + Qp''_Q(Q, \xi) \leq 0 \), for every \( Q \geq 0 \) and \( \xi \in \Xi \).

c) The cost function \( c_i(q_i), i = 1, 2, \ldots, M \), is twice continuously differentiable and \( c'_i(q_i) \geq 0 \) and \( c''_i(q_i) \geq 0 \) for any \( q_i \geq 0 \).

The assumption is fairly standard and used in Sherali et al. (1983), DeWolf and Smeers (1997) and Xu (2005) except the convexity of the inverse demand function. The convexity is required to establish some technical results in Lemma 3.1 and it covers a variety of demand functions such as linear multiplicative function, isoelastic function and logarithmic function. From the above assumptions and generators’ profit functions, we give the following proposition to show that each generator’s optimal dispatch quantity in the spot market does not depend on the strike price.

Proposition 2.3 Generator i’s optimal solution to (2.1) depends on the vector of contract quantities \( x \), the spot market scenario \( \xi \) and the spot dispatches \( \{ q_1, \ldots, q_M \} \) but not the strike prices \( \{ z_1(x), \ldots, z_l(x), \ldots, z_M(x) \} \). Moreover, if generator i’s contract quantity \( x_i \) is less than \( q_i^u \), then its marginal profit is negative for \( q_i > q_i^u \) under Assumptions 2.1 and 2.2.

Proof Consider the derivative of generator i’s profit maximization problem (2.1). Since \( \xi \), \( x_i \), \( Q_{-i} \) and \( z_i(x) \) are fixed, differentiating \( R_i \) w.r.t. \( q_i \), we have,

\[
\frac{\partial R_i(q_i, x, Q_{-i}, \xi)}{\partial q_i} = p(q_i + Q_{-i}, \xi) + (q_i - x_i)p'_q(q_i + Q_{-i}, \xi) - c'_i(q_i). \tag{2.2}
\]

Since the optimal solution is determined by the above derivative which is independent of \( z_i(x) \), the first part of the conclusion follows.

To show the second part of the proposition, note that \( p(q_i + Q_{-i}, \xi) - c'_i(q_i) < 0 \) for \( q_i \geq q_i^u \) under Assumption 2.1 and \( (q_i - x_i)p'_q(q_i + Q_{-i}, \xi) < 0 \) when \( q_i \geq q_i^u \) as \( q_i^u \geq x_i \) and \( p'_q(q_i + Q_{-i}, \xi) < 0 \). The conclusion follows.

By Proposition 2.3, we can add the capacity constraint explicitly to the profit maximization problem (2.1):

\[
\max_{q_i \in [0, q_i^u]} R_i(q_i, x, Q_{-i}, \xi) = q_i p(q_i + Q_{-i}, \xi) - c_i(q_i) - x_i p(q_i + Q_{-i}, \xi) + x_i z_i(x). \tag{2.3}
\]

A referee raised a question of whether we can replace the explicit capacity limit by assuming that \( c'_i(q) \) increases steeply as \( q_i \) approaches \( q_i^u \) but not mentioning \( q_i^u \) explicitly. The potential benefit of doing this is that we don’t need to consider the upper bound in the first order optimality conditions to be discussed in Sect. 3. The answer is yes. However, following Proposition 2.3, we can ignore the upper bound in the derivation of first order optimality conditions anyway because generator i’s optimum will not be achieved beyond \( q_i^u \). The additional benefit of giving an explicit \( q_i^u \) makes our profit maximization problem (2.3) well defined without specifying the properties of the underlying objective function.
2.2 Nash–Cournot equilibrium in the spot market

In the spot market, when market demand is realized, that is, every generator knows the inverse demand function \( p(\cdot, \xi) \) giving the relationship between the clearing price and the aggregate dispatch quantity, and each generator sets its optimal dispatch quantity to the pool market by solving profit maximization problem (2.1), which means that generators play a Nash–Cournot game in the spot market, a situation that no generator can improve its profit in the spot market by changing its dispatch unilaterally while the other players keep their bids fixed. Following Proposition 2.3, if there exists a Nash–Cournot equilibrium in the spot market, it must be independent of strike price \( z_i(x), \) for \( i = 1, 2, \ldots, M. \) A formal definition of such an equilibrium can be given as follows.

**Definition 2.4** A Nash–Cournot equilibrium in the spot market at demand scenario \( p(\cdot, \xi) \) is an \( M \)-tuple \((q_1(x_1, \xi), \ldots, q_M(x_1, \xi))\) where \( q_i(x_1, \xi) \) solves (2.3) for \( i = 1, \ldots, M. \)

**Remark 2.5** The dependence of \( q_i(x_1, \xi) \) on \( x_1 \) is intuitive and follows from Proposition 2.3. However, the dependence of \( q_i(x_1, \xi) \) on \( x_j \) needs some clarification. Let us look at (2.2). If we change \( x_j \) but \( q_j \) is not changed accordingly (e.g., \( q_j \equiv 0 \)) for \( j = 1, 2, \ldots, M \) and \( j \neq i, \) then \( Q_{-i} \) does not change. In this case, \( q_i(x_1, \xi) \) is not affected by the change of \( x_j. \) This implies that only when the change of \( x_j \) has an impact on \( Q_{-i}, \) it has an impact on \( \frac{\partial R_i(q_i(x_1, Q_{-i}, \xi), x)}{\partial q_i}, \) hence the optimal solution \( q_i(x_1, \xi). \) Practically, it means that a generator can influence a market equilibrium in the spot market only by changing its dispatch quantity to the spot market. We will use this observation in Proposition 3.7.

From theoretical point of view, there may exist multiple equilibria although in practice only one of them is reached. We denote the set of these equilibria by \( q(x, \xi). \) We also use \( q(x, \xi) = (q_1(x, \xi), \ldots, q_M(x, \xi))^T \) to denote an equilibrium in the set \( q(x, \xi). \) Note also that the market clearing price \( p(Q(x, \xi), \xi) \) is determined by the market equilibrium at the end of competition because the aggregate dispatch is \( Q(x, \xi) = \sum_{i=1}^M q_i(x, \xi). \)

2.3 Generator’s optimal decision problem in the forward market

In the forward market, when generators compete to sign contracts, they do not know what market clearing price will be in the spot market. We assume here that each generator knows: (a) generators play a Nash–Cournot game in the spot market; (b) there is an equilibrium in every scenario; (c) the inverse demand function \( p(\cdot, \xi) \) and the distribution of \( \xi. \)

Under these assumptions, generator \( i \)’s expected profit can be written as

\[
\pi_i(x_i, x_{-i}) := \mathbb{E} \left[ R_i(q_i(x_i, \xi), x, Q_{-i}(x_i, \xi), \xi) \right],
\]

where \( q_i(x, \xi) \) and \( Q_{-i}(x, \xi) \) correspond to some equilibrium \( q(x, \xi) \) in the spot market, and generator \( i \) aims to maximize its expected profit by choosing an optimal
contract quantity $x_i$. It is important to note that this is a statistical average that generator $i$ may expect before the competition in the spot market is realized.

Observe that if the spot market has multiple equilibria, then each generator may have its own prediction on an equilibrium $\mathbf{q}(x, \xi) \in \mathbf{q}(x, \xi)$, and consequently $\mathbf{q}(x, \xi)$ in the term $R_i(q_i(x, \xi), x, Q_i(x, \xi), \xi)$ in (2.4) may depend on $i$, that is, it takes a value depending on generator $i$’s view about the market equilibria. For instance, if generator $i$ is optimistic, then it may expect the best equilibrium situation, that is, to choose $\mathbf{q}(x, \xi) \in \mathbf{q}(x, \xi)$ such that $R_i(q_i(x, \xi), x, Q_i(x, \xi), \xi)$ is maximized. See a similar discussion by Pang and Fukushima (2005) in a deterministic Nash equilibrium model and Shapiro and Xu (2005) in a stochastic mathematical program with equilibrium constraints (SMPEC) model. Therefore, the expected profit of generator $i$ at the forward market can be formulated as:

$$\hat{\pi}_i(x_i, x_{-i}) := \mathbb{E} \left[ \max_{q(x, \xi) \in \mathbf{q}(x, \xi)} q_i(x, \xi) p(Q(x, \xi), \xi) - c_i(q_i(x, \xi)) - x_i p(Q(x, \xi), \xi) + x_i z_i(x) \right].$$

On the other hand, for a pessimistic generator $i$, it may expect the worst equilibrium situation, that is, to choose $\mathbf{q}(x, \xi) \in \mathbf{q}(x, \xi)$ such that $R_i(q_i(x, \xi), x, Q_i(x, \xi), \xi)$ is minimized, and the expected profit of generator $i$ at the forward market can be formulated as:

$$\bar{\pi}_i(x_i, x_{-i}) := \mathbb{E} \left[ \min_{q(x, \xi) \in \mathbf{q}(x, \xi)} q_i(x, \xi) p(Q(x, \xi), \xi) - c_i(q_i(x, \xi)) - x_i p(Q(x, \xi), \xi) + x_i z_i(x) \right].$$

Let us now focus on the strike price in the forward market. In practice, most generators are risk neutral. That means, with the perfect knowledge of the distribution of the demand scenario $\xi$, no generator will sign a contract at a strike price lower than the expected spot price, and similarly retailers will find no advantage to sign a contract at a strike price higher than the expected spot price. For the simplicity of discussion, we assume that every generator and retailer are risk neutral and they have the same view on a market equilibrium. This leads to the following assumption.

**Assumption 2.6** The strike price in the forward market equals the expected spot market price, that is,

$$z_i(x) \in \mathbb{E}[p(Q(x, \xi), \xi)] : Q(x, \xi) = q^T(x, \xi)e, \ q(x, \xi) \in \mathbf{q}(x, \xi), (2.5)$$

where $e$ is an $M$-dimensional vector with unit components.
identical strike price, that is, \( z_1(x) = \cdots = z_M(x) \). Of course, if the spot market has multiple equilibria, and each generator has different view on a market equilibrium, then \( z_i(x), i = 1, \ldots, M \) may take different values and a contract can be agreed only when both parties of the contract have the same view on spot market equilibrium.

2.4 Nash–Cournot equilibrium in the forward market

For the simplification of discussion, we assume that \( z_1(x) = \cdots = z_M(x) \) either because generators have the same views on spot market equilibrium or there is a unique equilibrium in every scenario. From a practical perspective, it means that, to each generator, every unit of contract defines the same obligation of energy dispatching in the spot market. Therefore, the expected profits of generators at the forward market can be rewritten as

\[
\pi_i(x_i, x_{-i}) = \mathbb{E}[q_i(x, \xi)p(Q(x, \xi), \xi) - c_i(q_i(x, \xi))],
\]

for \( i = 1, \ldots, M \) and its decision problem in the forward market is

\[
\max_{x_i \geq 0} \pi_i(x_i, x_{-i}) = \mathbb{E}[q_i(x, \xi)p(Q(x, \xi), \xi) - c_i(q_i(x, \xi))], \quad i = 1, \ldots, M, \tag{2.6}
\]

that is, generators play a Nash–Cournot game when they compete to sign contracts in the forward market. We are interested in the outcome of competition by looking into an equilibrium of the Nash–Cournot game.

**Definition 2.7** A stochastic equilibrium in the forward-spot market is a \( 2M \) tuple \((x_1^*, \ldots, x_M^*, q_1^*(x^*, \xi), \ldots, q_M^*(x^*, \xi))\) such that

\[
\pi_i(x_i^*, x_{-i}^*) = \max_{x_i \geq 0} \pi_i(x_i, x_{-i}), \quad i = 1, \ldots, M, \tag{2.7}
\]

\[
q_i(x^*, \xi) \in \arg \max_{q_i \geq 0} R_i(q_i(x^*, \xi), x^*, Q_{-i}(x^*, \xi), \xi), \quad i = 1, \ldots, M, \quad \forall \xi \in \Xi, \tag{2.8}
\]

and \((q_1(x^*, \xi), \ldots, q_M(x^*, \xi))\) is a Nash–Cournot equilibrium in demand scenario \( p(\cdot, \xi) \).

The problem is essentially an SEPEC. Recently DeMiguel and Xu (2008) propose a stochastic multiple leader Stackelberg (SMS) model for a general oligopoly market where a group of firms compete to supply homogeneous goods to a future market and they model the problem as an SEPEC. The model extends Sherali’s deterministic multiple-leader model (Sherali 1984) and De Wolf and Smeers’ stochastic single-leader model (DeWolf and Smeers 1997). However, there are some fundamental differences between this model and the SMS model: (a) In the SMS model, only a few strategic firms (leaders) play a Nash–Cournot game at the first stage and the non-strategic firms (followers) do not participate in the competition. In our model, all generators compete in the forward market. (b) In the SMS model, leaders do not
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compete at the second stage after market demand is realized, and their commitments (supply) at the first stage are treated as given and consequently followers only compete for a residual demand. In our model, every generator must compete for dispatch in the spot market and their optimal strategy is affected by their commitments to forward contracts.

3 Equilibrium in the spot market

In this section, we investigate in detail Nash–Cournot equilibrium in the spot market at demand scenario \( p(\cdot, \xi) \). We are particularly concerned with existence, uniqueness of equilibrium and properties of equilibrium as a function of forward contracts.

3.1 Existence and uniqueness of the equilibrium

First, before presenting further analysis on the existence and uniqueness of the equilibrium, we give some results on the strict concavity of each generator’s profit function.

**Lemma 3.1** Under Assumption 2.2, for every \( Q \geq 0 \) and \( \xi \in \Xi \)

(i) \( Qp(Q + K, \xi) \) is a concave function for any fixed \( K \geq 0 \).

(ii) For any fixed \( K \geq 0 \) and \( X \geq 0 \), \( (Q - X)p(Q + K, \xi) \) is a strictly concave function of \( Q \) for \( Q \geq 0 \).

The proof to Lemma 3.1 is given in the appendix. From the strict concavity of the function \( (Q - X)p(Q, \xi) \), we can verify that each generator’s objective function, \( Ri(q_i, x, Q - i, \xi) \), is strictly concave w.r.t. \( q_i \) for fixed \( Q - i \geq 0 \), \( x \geq 0 \) and \( \xi \in \Xi \).

**Proposition 3.2** Let \( Ri(q_i, x, Q - i, \xi) \) be defined as in (2.1). Under Assumptions 2.6 and 2.2, \( Ri(q_i, x, Q - i, \xi) \) is strictly concave w.r.t. \( q_i \).

The conclusion follows straightforwardly from the convexity of \( c_i(q_i) \) and the concavity of \( (q_i - x_i)p(q_i + Q - i, \xi) \) that is proved in Lemma 3.1 (ii).

**Proposition 3.3** Under Assumptions 2.1, 2.6 and 2.2, for every fixed \( x_i \in [0, +\infty) \), \( i = 1, 2, \ldots, M \) and \( \xi \in \Xi \), there exists a unique Nash–Cournot equilibrium in the spot market, \( q(x, \xi) = (q_1(x, \xi), \ldots, q_M(x, \xi))^T \), which solves the following problem

\[
q_i(x, \xi) \in \arg \max_{q_i \geq 0} \{ Ri(q_i, x, Q - i, \xi) = (q_i - x_i)p(q_i + Q - i, \xi) - c_i(q_i) + x_iz_i(x) \}.
\]

Moreover, \( q_i(x, \xi) \in [0, \max\{q_i^u, x_i\}] \), for any fixed \( x \) and \( \xi \) with \( i = 1, \ldots, M \).

**Proof** Since generator \( i \)'s objective function \( Ri(q_i, x, Q - i, \xi) \), is strictly concave in \( q_i \) (here \( x, \xi \) are parameters), the existence of equilibrium follows from Rosen (1965, Theorem 1) while the uniqueness follows from Rosen (1965, Theorem 2) because the strict concavity implies the diagonally strict concavity of a weighted non-negative sum.
of the objective functions. Let us now look into the boundedness of the equilibrium. Because, for any fixed \( \xi \in \Xi \) and \( x_i \geq 0 \), \( R_i(q_i, x, Q_{-i}, \xi) \) is strictly concave, we have

\[
\frac{dR_i(q_i, x, Q_{-i}, \xi)}{dq_i} = p(q_i + Q_{-i}, \xi) + q_i p'_{Q}(q_i + Q_{-i}, \xi)
\]

\[
- c'_i(q_i) - x_i p'_Q(q_i + Q_{-i}, \xi)
\]

\[
\leq p(q_i, \xi) + q_i p'_Q(q_i + Q_{-i}, \xi) - c'_i(q_i) - x_i p'_Q(q_i + Q_{-i}, \xi)
\]

\[
\leq (q_i - x_i) p'_Q(q_i + Q_{-i}, \xi) \leq 0,
\]

for any \( q_i \geq \max\{q_i^u, x_i\} \). Hence, \( R_i \) achieves maximum in \([0, \max\{q_i^u, x_i\}]\). \( \square \)

3.2 Properties of the equilibrium in the spot market

We now investigate properties of Nash–Cournot equilibrium \( q(x, \xi) \) in the spot market by taking it as a function of \( x \) and \( \xi \). We will also investigate the monotonicity of aggregate dispatch function \( Q(x, \xi) \) w.r.t. \( x_i \) for \( i = 1, 2, \ldots, M \). We do so by reformulating the Nash–Cournot equilibrium problem in the spot market as a nonlinear complementarity problem. The KKT conditions of the Nash–Cournot equilibrium problem can be written as

\[
p(Q, \xi) + (q_i - x_i) p'_Q(Q, \xi) - c'_i(q_i) + \mu_i = 0,
\]

\[
0 \leq \mu_i \perp q_i \geq 0, \quad (3.9)
\]

for \( i = 1, 2, \ldots, M \), where \( 0 \leq \mu_i \perp q_i \geq 0 \) denotes that \( q_i \geq 0, \mu_i \geq 0 \) and at least one of them is equal to zero.

Denote generators’ cost functions in a vector-valued form as \( c(q) = (c_1(q_1), \ldots, c_M(q_M))^T \) and \( e = (1, \ldots, 1)^T \) with an appropriate dimension. Define a vector-valued function

\[
G(q, x, \xi) := -p(q^T e, \xi)e - (q - x) p'_Q(q^T e, \xi) + \nabla c(q),
\]

where \( \nabla c(q) := (c'_1(q_1), \ldots, c'_M(q_M))^T \). The complementarity problem (3.9) can be rewritten as

\[
0 \leq q \perp G(q, x, \xi) \geq 0. \quad (3.10)
\]

Consequently, each generator’s decision problem can be reformulated as a stochastic mathematical program with complementary constraints (SMPCC), where, for every \( i = 1, \ldots, M \), generator \( i \)’s decision problem is

\[
\max_{x_i \geq 0} \mathbb{E}[q_i(x, \xi) p(Q(x, \xi), \xi) - c_i(q_i(x, \xi))]
\]

s.t. \( q(x, \xi) \) solves \( 0 \leq q \perp G(q, x, \xi) \geq 0, \ \xi \in \Xi \).
It is well known that (3.10) can be reformulated as a system of nonsmooth equations as

\[
F(q, x, \xi) := \min(G(q, x, \xi), q) = 0,
\]

where ‘min’ is taken componentwise.

In what follows, we use Eq. (3.11) to investigate the dependence of \( q \) on \( x \) and \( \xi \). Observe that \( F \) is only piecewise smooth, therefore we need to use the Clarke generalized implicit function theorem rather than the classical implicit function theorem to derive the implicit function \( q(x, \xi) \) defined by (3.11).

**Definition 3.4** (Clarke generalized Jacobian/subdifferential) Let \( H : \mathbb{R}^n \to \mathbb{R}^m \) be a Lipschitz continuous function. The Clarke generalized Jacobian (Clarke 1983) of \( H \) at \( w \in \mathbb{R}^n \) is defined as

\[
\partial H(w) \equiv \text{conv}\left\{ \lim_{y \to w} \nabla H(y) \in D_H, y \in \mathbb{R}^n \right\},
\]

where ‘conv’ denotes the convex hull of a set and \( D_H \) denotes the set of points in a neighborhood of \( x \) at which \( H \) is Frechét differentiable.

When \( m = 1 \) or \( n = 1 \), \( \partial H \) is also called Clarke subdifferential. When \( n = m \), the Clarke generalized Jacobian \( \partial H(x) \) is said to be non-singular if every matrix in \( \partial H(x) \) is non-singular. From Definition 3.4, we can observe that the Clarke subdifferential coincides with the usual gradient \( \nabla H(x) \) at the point \( x \) where \( H(\cdot) \) is strictly differentiable. Note that a number of functions in this paper are piecewise continuously differentiable, which means that at “most” points, the Clarke subgradient coincides with the classical gradient. The additional benefit of the Clarke notion provides us a derivative tool to deal with a “few” points where the classical derivatives do not exist and traditional right/left derivative approach make discussions complicated and indeed not working when dealing with vector valued functions. By using the Clarke notion, we have a unified derivative tool for both “differentiable points” and “nondifferentiable points”.

**Theorem 3.5** Let \( F(q, x, \xi) \) be defined as in (3.11). Under Assumptions 2.1, 2.2 and 2.6, the following results hold.

(i) \( \partial_q F(q, x, \xi) \) is non-singular for \( q \geq 0 \) and \( x \geq 0 \).

(ii) For every \( x \geq 0 \) and \( \xi \in \Xi \), there exists a unique \( q \) such that \( F(q, x, \xi) = 0 \).

(iii) There exists a unique Lipschitz continuous and piecewise smooth function \( q(x, \xi) \) defined on \( [0, +\infty) \times \Xi \) such that

\[
F(q(x, \xi), x, \xi) = 0.
\]

The theorem above shows that under Assumptions 2.1, 2.2 and 2.6, there exists a unique Nash–Cournot equilibrium in the spot market for every \( x \) and \( \xi \), and the equilibrium is a vector valued function of \( x \) and \( \xi \) which is Lipschitz continuous and piecewise smooth. In what follows, we investigate the subdifferentials of the dispatch.
function \( q(x, \xi) \) in the spot equilibrium and the aggregate dispatch \( Q(x, \xi) \) w.r.t. \( x_i \) and \( \xi \). This is to examine the impact of the changes of individual generator’s contract level and random shock \( \xi \) on the market equilibrium and the aggregate dispatch in the spot market. We need the following assumption to guarantee that, for every demand scenario, there is at least one generator whose dispatch quantity to the spot market is strictly positive. Obviously, this is always satisfied in the real electricity market.

**Assumption 3.6** Suppose that, for every \( \xi \in \Xi \) and \( x \) signed in the forward market, the inverse demand function \( p(\cdot, \xi) \) and the cost functions \( c_i(\cdot) \) satisfy

\[
\min_{i=1, \ldots, M} c_i'(0) < p(Q(x, \xi), \xi). \tag{3.12}
\]

The assumption implies that at any demand scenario, and for any contract quantities \( x \) signed in the forward market, there is at least one generator whose marginal cost of producing a very small amount of electricity is strictly lower than the market clearing price, which means that there exists at least one generator which is profitable by supplying a small amount of electricity in the spot market. This assumption excludes the case that no generator is willing to sell electricity in a particular scenario.

**Proposition 3.7** Let \( F(q, x, \xi) \) be defined as in (3.11). Under Assumptions 2.1, 2.2, 2.6 and 3.6, we have the following.

(i) The Clarke generalized Jacobian of \( q(x, \xi) \) w.r.t. \( x \) can be estimated as follows:

\[
\partial_x q(x, \xi) \subset \text{conv} \left\{ -W^{-1}U : (W, U, V) \in \partial F(q(x, \xi), x, \xi), \right. \\
W \in \mathbb{R}^{M \times M}, U \in \mathbb{R}^M, V \in \mathbb{R} \right\}. \tag{3.13}
\]

(ii) The Clarke subdifferential of the aggregate dispatch function, \( Q(x, \xi) \), w.r.t. \( x_i \), for \( i = 1, \ldots, M \), can be estimated as

\[
\partial_{x_i} Q(x, \xi) \subset [0, 1).
\]

The lower bound is reached only when \( q_i(x, \xi) = 0 \).

(iii) The Clarke subdifferential of generator i’s dispatch function, \( q_i(x, \xi) \), w.r.t. \( x_i \), can be estimated as

\[
\partial_{x_i} q_i(x, \xi) \subset [0, 1).
\]

The lower bound is reached only when \( q_i(x, \xi) = 0 \).

(iv) The Clarke subdifferential of \( q_i(x, \xi) \), w.r.t. \( x_j \) can be estimated as

\[
\partial_{x_j} q_i(x, \xi) \subset (-1, 0].
\]

The upper bound is reached only when \( q_j(x, \xi) = 0 \).
(v) If \( p''_{Q,\xi}(Q, \xi) = 0 \), then \( q_i(x, \xi) \) is an increasing function of \( \xi \); moreover, if there exists a constant \( C \geq 0 \) such that

\[
p'_{Q}(Q, \xi) + p''_{Q}(Q, \xi)(q - x)^T e < -C, \quad \text{for } Q \geq 0, x \geq 0 \text{ and } \xi \in \Xi;
\]

then the Clarke subdifferential of \( Q(x, \xi) \) w.r.t. \( \xi \) can be estimated as follows:

\[
\partial_{\xi} Q(x, \xi) \subset \left( 0, \frac{1}{C} p'_\xi(Q(x, \xi), \xi) \right].
\]

We provide a proof on these technical results in the appendix. Moreover, some economic interpretations for these results can be given as following: Part (ii) indicates that every unit increase of contract quantity by a generator in the forward market will result in an increase of the aggregate dispatch of all generators in the spot market by less than one unit. Part (iii) has a similar interpretation for an individual generator. Part (iv) means that generator \( i \)'s dispatch will be reduced by less than one unit if one of its rivals increases one unit in its contract quantity.

To give an intuitive interpretation of the results in this section, we present a simple example of a duopoly market.

**Example 3.8** Consider an electricity market with two generators, \( A \) and \( B \). The generators’ cost functions are

\[
c_A(q_A) = 0.8q_A, \quad c_B(q_B) = q_B,
\]

where \( q_A \) and \( q_B \) denote \( A \) and \( B \)’s quantities for dispatches in the spot market, respectively. We assume that the inverse demand function is

\[
p(q_A + q_B, \xi) = \alpha(\xi) - \beta(q_A + q_B),
\]

where \( \alpha(\xi) = 7 + \xi, \beta = 2 \), and the random shock \( \xi \) follows a uniform distribution on the set \([0, 1]\). Denote the contract positions of \( A \) and \( B \) in the forward market by \( x_A \) and \( x_B \). The inverse demand function after the realization of the random shock \( \xi \) is

\[
p(q_A + q_B, \xi) = 7 + \xi - 2(q_A + q_B).
\]

Let \( q_A^u = 3.6 \) and \( q_B^u = 3.5 \) be the capacity limits of \( A \) and \( B \). In the spot market, generator \( A \) and \( B \)’s profit maximization problems can be respectively written as

\[
\begin{align*}
\max_{q_A \in [0, q_A^u]} R_A(q_A, q_B, x, \xi) &= -2q_A^2 + 2q_A(6.2 - 2q_B + \xi + 2x_A) - x_A(7 - 2q_B + \xi), \\
\max_{q_B \in [0, q_B^u]} R_B(q_B, q_A, x, \xi) &= -2q_B^2 + q_B(6 - 2q_A + \xi + 2x_B) - x_B(7 - 2q_A + \xi),
\end{align*}
\] (3.14)
It is easily verify that, for any \( \xi \in [0, 1] \), \( \forall q_A \geq q_A^* \) and \( \forall q_B \geq q_B^* \), we have the following inequalities,

\[
p(q_A, \xi) \leq 7 + \xi - 2q_A^* \leq 0.8 = c_A'(q_A),
\]

\[
p(q_B, \xi) \leq 7 + \xi - 2q_B^* \leq 1 = c_B'(q_B),
\]

which imply that Assumption 2.1 holds in this example. According to our discussion following Assumption 2.1, (3.15) implicitly ensures that the optimal solution \( q_i^*(x, \xi) \) satisfy \( q_i^*(x, \xi) \leq q_i^* \) for \( i = A, B \) and will never go beyond \( q_A^* \) and \( q_B^* \) in every scenario \( \xi \in \Xi \). Therefore, the constraints \( q_i \leq q_i^* \) for \( i = A, B \) in (3.14) are not active, and generator A and B’s profit maximization problems can be respectively reformulated as

\[
\max_{q_A \geq 0} R_A(q_A, q_B, x, \xi) = -2q_A^2 + q_A(6.2 - 2q_B + \xi + 2x_A) - x_A(7 - 2q_B + \xi),
\]

\[
\max_{q_B \geq 0} R_B(q_B, q_A, x, \xi) = -2q_B^2 + q_B(6 - 2q_A + \xi + 2x_B) - x_B(7 - 2q_A + \xi),
\]

where \( R_A \) and \( R_B \) are quadratic functions. Therefore, the optimal dispatches in the spot market satisfy the following first-order conditions:

\[
0 \leq q_A(x, \xi) \perp 4q_A(x, \xi) - (6.2 - 2q_B(x, \xi) + \xi + 2x_A) \geq 0,
\]

\[
0 \leq q_B(x, \xi) \perp 4q_B(x, \xi) - (6 - 2q_A(x, \xi) + \xi + 2x_B) \geq 0.
\]

Note that, the case \( q_A = q_B = 0 \) is excluded by Assumption 3.6 for (3.17). From (3.16), we have

\[
(q_A(x, \xi), q_B(x, \xi)) = \begin{cases} 
(0, \frac{1}{4}(2x_B + 6 + \xi)), & \text{if } q_A = 0; \\
(\frac{1}{4}(2x_A + 6.2 + \xi), 0), & \text{if } q_B = 0; \\
(\frac{1}{6}(4x_A - 2x_B + \xi + 6.4), \frac{1}{6}(4x_B - 2x_A + \xi + 5.8)), & \text{otherwise}.
\end{cases}
\]

Equation (3.17) implies that \( \partial_x q_i \) is a subset of \( [0, 1/2] \) or \( [1/2, 2/3] \) for \( i = A, B \), and \( \partial_x q_i \subset [-1/3, 0] \) for \( i, j = A, B \) and \( i \neq j \), which verifies the results (iii) and (iv) in Proposition 3.7. Moreover, the aggregated dispatch quantity can be written as

\[
Q(x, \xi) = \begin{cases} 
\frac{1}{4}(6 + \xi + 2x_B), & \text{if } q_A = 0; \\
\frac{1}{4}(6.2 + \xi + 2x_A), & \text{if } q_B = 0; \\
\frac{1}{3}(6.1 + \xi + x_A + x_B), & \text{otherwise},
\end{cases}
\]

which implies \( \partial_x Q \) is a subset of \( [0, 1/2] \) or \( [1/3, 1/2] \), and hence the result (ii) in Proposition 3.7. Observe that (3.17) and (3.18) provide us with a further properties, that is, at the demand scenario \( \xi \), if \( q_i(x, \xi) \equiv 0 \) for every \( x \), then \( \partial_x q_i(x, \xi) \equiv 0 \) for \( i, j = A, B \) and \( \partial_x Q(x, \xi) \equiv 0 \). This fact verifies the lower bounds in the results (ii) and (iii), and the upper bound in the result (iv) in Proposition 3.7.
4 Equilibrium in the forward market

In this section, we investigate the competition in the forward market. We do so by looking into the existence of a Nash–Cournot equilibrium in the forward market as defined in Definition 2.7. For the simplification of discussion, we assume that the spot market has a unique Nash–Cournot equilibrium, \( q(x, \xi) = (q_1(x, \xi), q_2(x, \xi), \ldots, q_M(x, \xi))^T \) for every \( x \) and \( \xi \). First, from Proposition 3.7, we can establish a relationship between the strike price and the contract quantities in the following proposition.

**Proposition 4.1** Under Assumptions 2.1, 2.2 and 2.6, the strike price \( z \) is a function of the contract quantities \( x \), that is, \( z(x) = \mathbb{E}[p(Q(x, \xi), \xi)] \). Moreover, the elements in the set \( \partial_{x_i} z(x) \) are all non-positive.

**Proof** Under Assumption 2.6 and the uniqueness of the supply functions \( q_i(x, \xi) \) in the spot equilibrium, we have, \( z(x) = \mathbb{E}[p(Q(x, \xi), \xi)] \). The Clarke subdifferential of \( z(x) \) is

\[
\partial_{x_i} z(x) = \partial_{x_i} \mathbb{E}[p(Q(x, \xi), \xi)].
\]

Since the inverse demand function \( p(Q, \xi) \) is a continuously differentiable function of \( Q \) (see Assumption 2.2), and \( Q(x, \xi) \) is a Lipschitz continuous function of each \( x_i \) proved in Proposition 3.5(iii), we have, \( p(Q(x, \xi), \xi) \) is also a Lipschitz continuous function of \( x_i \). Therefore, from Clarke (1983, Theorem 2.7.5),

\[
\partial_{x_i} \mathbb{E}[p(Q(x, \xi), \xi)] \subset \mathbb{E}[\partial_{x_i} p(Q(x, \xi), \xi)] \subset \mathbb{E}[p'_Q(x, \xi) \partial_{x_i} Q(x, \xi)].
\]

Moreover, by Part (ii) of Theorem 3.5,

\[
\mathbb{E}[p'_Q(Q(x, \xi), \xi) \partial_{x_i} Q(x, \xi)] \subset (p'_Q(Q(x, \xi), \xi), 0] \subset (-\infty, 0].
\]

This completes the proof.

Proposition 4.1 establishes a relationship between the strike price and a generator’s contract quantity in the forward market, in which the negativity of the elements in \( \partial_{x_i} z(x) \) implies that any unilateral increase of the contract quantity by a generator never results in an increase of the strike price.

4.1 Differentiability of the expected profit

We now discuss the continuity and differentiability of a generator’s objective function in the forward market and investigate the change of the expected profit of an individual generator against the change of its contract quantity. To avoid too much mathematical details and make our analysis more readable, we move all the detailed proofs of the lemmas and theorem in this subsection to the appendix. We start by considering the
first order derivative. Recall that
\[ \pi_i(x_i, x_{-i}) := \int_{\xi \in \Xi} [q_i(x, \xi) p(Q(x, \xi), \xi) - c_i(q_i(x, \xi))] \rho(\xi) d\xi, \]
for \( i = 1, 2, \ldots, M. \)

Obviously, the only component in the integrand which may cause nondifferentiability of the integrand and hence \( \pi_i(x_i, x_{-i}) \) is \( q_j(x_i, \xi), j = 1, \ldots, M \) and \( j \neq i \).

In what follows, we demonstrate that under some moderate condition, the piecewise smoothness of \( q(x, \xi) \) may not cause nondifferentiability of \( \pi_i(x_i, x_{-i}) \).

**Assumption 4.2** The inverse demand function and the cost functions satisfy the following.

(i) For any fixed \( \xi \in \Xi \), there exists an \( L_1(\xi) \geq 0 \) such that
\[
\max (-p'_Q(Q(x, \xi), \xi), p''_Q(Q(x, \xi), \xi), c_i(q_i(x, \xi))) \leq L_1(\xi),
\]
for all \( x_i \geq 0, \ i = 1, 2, \ldots, M, \)

and \( \sup_{\xi \in \Xi} L_1(\xi) < \infty. \)

(ii) There exists a constant \( \sigma \geq 0 \) such that \( -p'_Q(Q(x, \xi), \xi) + c_i''(q_i(x, \xi)) > \sigma, \)
for all \( \xi \in \Xi \) and \( x_i \geq 0 \) for \( i = 1, 2, \ldots, M. \)

Under Assumption 4.2, we need a couple of intermediate results, Lemmas 4.3 and 4.4, to obtain the main result on the twice continuous differentiability of \( q_i(x, \xi) \) w.r.t. \( x_i \) in Theorem 4.5. For the clarity of notation, we write \( q_i(x, \xi) \) as \( q_i(x_i, x_{-i}, \xi) \) to distinguish \( x_i \) and \( x_{-i} \) because \( x_{-i} \) will be treated as parameters when we analyze the sensitivity of the quantities w.r.t. \( x_i \).

**Lemma 4.3** Under Assumptions 2.1, 2.6, 2.2, 3.6 and 4.2, the following results hold.

(i) For each \( i = 1, \ldots, M, \) \( q_i(x_i, x_{-i}, \xi) \) is a piecewise continuously differentiable and increasing function of \( x_i \).

(ii) For \( x_j \geq 0, j = 1, 2, \ldots, M, \) \( j \neq i \) and \( \xi \in \Xi, q_i(x_i, x_{-i}, \xi) \) is globally Lipschitz continuous w.r.t. \( x_i; \) that is, there exists a function \( L^i_2(\xi), i = 1, \ldots, M, \)

such that
\[
|q_i(x^{(1)}_i, x_{-i}, \xi) - q_i(x^{(2)}_i, x_{-i}, \xi)| \leq L^i_2(\xi)|x^{(1)}_i - x^{(2)}_i|, \quad \forall x^{(1)}_i, x^{(2)}_i \geq 0,
\]

where \( \int_{\xi \in \Xi} L^i_2(\xi) \rho(\xi) d\xi < \infty. \)

From the part (i) of Lemma 4.3, we know that \( q_i(x_i, x_{-i}, \xi) \) is a nondecreasing function in \( x_i, \) and thus there exists a unique point at which \( q_i(x_i, x_{-i}, \xi) \) turns from zero to positive as \( x_i \) increases, and we denote this point by \( x_i(\xi). \) In economic terms, given the contract position \( x_{-i} \) signed by generator \( i \)'s rivals, for a realized demand shock \( \xi \in \Xi, x_i(\xi) \) is the contract position at which generator \( i \)'s marginal profit in the spot market becomes from zero to positive, and its dispatch quantity also becomes
from zero to positive. Mathematically, $x_i(\xi)$ can be regarded as a degenerate point of the complementarity problem (3.10) because at this point, both $G_i(q(x, \xi), x_i, \xi)$ and $q_i(x_i, x_{-i}, \xi)$ are equal to zero. Note that $q_i(x_i, x_{-i}, \xi)$ is not differentiable w.r.t. $x_i$ at the point $x_i(\xi)$. From a practical perspective, part (i) of Lemma 4.3 implies that, the more contracts (in the sense of quantities) a generator signs in the forward market, the more dispatch the generator will commit in the spot market.

In what follows, we investigate the set of degenerate points $x_i(\xi)$ for a given $x$. This is because these degenerate points may result in non-differentiability of the integrand of $\pi_i(x_i, x_{-i})$ and potentially further result in the non-differentiability of $\pi_i(x_i, x_{-i})$ if there are too many such points (in the sense that the Lebesgue measure of the set of such points is non-zero). The following lemma states that the number of degenerate points are actually finite which implies that they will not cause non-differentiability of $\pi_i(x_i, x_{-i})$.

**Lemma 4.4** Let $\mathcal{E}_i(x) := \{ \xi \in \mathcal{E} | x_i = x_i(\xi) \}$ and $\mathcal{E}(x) := \bigcup_{i=1}^{M} \mathcal{E}_i(x)$. Under Assumptions 2.1, 2.6, 2.2, 3.6 and 4.2, $\mathcal{E}(x)$ is a finite set for any $x$.

Note that, from the definition of $\mathcal{E}(x)$, given $x$, $\mathcal{E}_i(x) \neq \emptyset$ means that there is a $\xi$ such that generator $i$'s dispatch quantity $q_i(x_i, x_{-i}, \xi)$ turns from zero to strictly positive, that is, the $i$th element of $x$ is $x_i(\xi)$. Therefore, $\mathcal{E}_i(x)$ is the set of points $\xi \in \mathcal{E}$ at which generator $i$’s dispatch quantity turns from zero to positive, and $\mathcal{E}(x)$ is the set of points $\xi \in \mathcal{E}$ at which the dispatch quantity of at least one of generators turns from zero to positive.

As observed in the proof of Lemma 4.4 in the appendix, $x_i(\xi)$ is a decreasing function of $\xi$ to maintain the property that $q_i(x_i(\xi), x_{-i}, \xi) \equiv 0$ for $x_i \leq x_i(\xi)$ and $q_i(x_i(\xi), x_{-i}, \xi) > 0$ for $x_i > x_i(\xi)$. For given $x_{-i}$ and $x_i$, let us define

$$v_i(x_i, \xi) := (q_i(x_i, x_{-i}, \xi) - x_i)p(Q(x, \xi), \xi) - c_i(q_i(x_i, x_{-i}, \xi)). \quad (4.19)$$

The only values of $\xi$ at which $v_i(\cdot, \xi)$ might not be differentiable w.r.t. $x_i$ are points $\xi$ at which the dispatch of one of generator turns from positive to zero. These are only points at which $Q(x, \xi)$ might not be differentiable w.r.t. $x_i$ and thus $v_i(\cdot, \xi)$ might not be differentiable w.r.t. $x_i$. By Lemma 3.4 in DeMiguel and Xu (2008), $\mathcal{E}_i(x_i)$ is a finite set, which implies that $Q(x, \xi)$ is differentiable w.r.t. $x_i$ for almost every $\xi \in \mathcal{E}$ and thus $v_i(x_i, \xi)$ is differentiable w.r.t. $x_i$ for almost every $\xi \in \mathcal{E}$. We are now able to address the main results of this section.

**Theorem 4.5** Suppose that there exists $L_3(\xi) \geq 0$ such that $\int_{\mathcal{E}} L_3(\xi) \rho(\xi) d\xi < \infty$ and

$$\max \left( p(Q, \xi), |p''(Q, \xi)|, |Q''(x, \xi)| \right) \leq L_3(\xi),$$

for all $Q \geq 0$, $\xi \in \mathcal{E}$ and $x_i$ with $i = 1, \ldots, M$, at which $Q(x, \xi)$ is twice continuously differentiable w.r.t. $x_i$. Then, under Assumptions 2.1, 2.6, 2.2, 3.6 and 4.2, $\pi_i(x_i, x_{-i})$ is twice continuously differentiable.
In what follows, we explain Theorem 4.5 through a simple example based on Example 3.8.

Example 4.6 (Continued from Example 3.8) Consider a duopoly market as described in Example 3.8. From the definition, for any fixed \( x_B \), the degenerate point \( x_A(\xi) \) (at which \( q_A(x_A, x_B, \xi) \) turns from zero to positive as \( x_A \) increases) can be identified by solving the following equations

\[
q_A(x_A(\xi), x_B, \xi) = 0; \quad \text{and} \quad 4q_A(x, \xi) - (6.2 - 2q_B(x_A(\xi), x_B, \xi) + \xi + 2x_A(\xi)) = 0,
\]

where \( x_A(\xi) \geq 0 \). By solving (3.16), we obtain

\[
x_A(\xi) = \frac{1}{2}(x_B - 0.5\xi - 3.2), \quad \text{for fixed } x_B.
\]

(4.20)

Combining the condition that \( x_A(\xi) \geq 0 \), we can see that for fixed \( x_A \) there exists at most one \( \xi \) such that \( q_A(x_A, x_B, \xi) \) is possibly not differentiable. This implies that the cardinality of the set \( \Xi_A(x) \) is at most 1, and hence verifies Lemma 4.4.

In what follows, we look into Theorem 4.5. For the sake of simplicity, we only verify the differentiability of \( \pi_A(x_A, x_B) \) in \( x_A \leq 1 \) and \( x_B \leq 3.2 \). We can obtain \( q_A \) and \( q_B \) by solving the following complementarity problem:

\[
4q_A(x_A, x_B, \xi) - (6.2 - 2q_B(x_A, x_B, \xi) + \xi + 2x_A) = 0,
\]

\[
0 \leq q_B(x_A, x_B, \xi) \perp 4q_B(x_A, x_B, \xi) - (6 - 2q_A(x_A, x_B, \xi) + \xi + 2x_B) \geq 0.
\]

(4.21)

From (3.15) in Example 3.8, \( q_A \) and \( q_B \) can be expressed as:

\[
\begin{align*}
(q^I_A, q^I_B) &= \left( \frac{1}{4}(6.2 + \xi + 2x_A), 0 \right), & \text{if } \xi \in [0, 2x_A - 4x_B - 5.8], \\
(q^{II}_A, q^{II}_B) &= \left( \frac{1}{6}(6.4 + \xi + 4x_A - 2x_B), 1 \right), \\
&= \left( \frac{1}{6}(5.8 + \xi + 4x_B - 2x_A) \right), & \text{if } \xi \in [2x_A - 4x_B - 5.8, 1],
\end{align*}
\]

where the two smooth pieces \( \{(q^I_A, q^I_B)\} \) and \( \{(q^{II}_A, q^{II}_B)\} \) intersect at the point \( x_A = 2x_B + 2.9 + 0.5\xi \), where \( (q^I_A, q^I_B) = (q^{II}_A, q^{II}_B) = \left( \frac{6.2 + \xi + 2x_A}{4}, 0 \right) \). In other words, at any fixed point \( x_A \) and \( x_B \), there is at most one \( \xi \) such that \( q_A \) and \( q_B \) are not differentiable w.r.t. variable \( x_A \). Consequently, generator A’s expected profit in the forward market can be calculated as follows:

1 As we can do for \( x_B \) in the same way.
2 There will be two nondifferentiable points when \( x_B > 3.2 \).
A two stage stochastic equilibrium model for electricity markets with two way contracts

\[ \pi_A(x_A, x_B) = \begin{cases} 
\int_{0}^{1} \left[ q_A^I p(Q^I, \xi) - c_A(q_A^I) \right] \rho(\xi) d\xi, & \text{if } \bar{\xi} \geq 1; \\
\int_{0}^{\bar{\xi}} \left[ q_A^I p(Q^I, \xi) - c_A(q_A^I) \right] \rho(\xi) d\xi + \int_{\bar{\xi}}^{1} \left[ q_A^{II} p(Q^{II}, \xi) - c_A(q_A^{II}) \right] \rho(\xi) d\xi, & \text{if } 0 < \bar{\xi} < 1; \\
\int_{0}^{1} \left[ q_A^{II} p(Q^{II}, \xi) - c_A(q_A^{II}) \right] \rho(\xi) d\xi, & \text{if } \bar{\xi} \leq 0,
\end{cases} \]

where \( Q^I = q_A^I + q_B^I, \) \( Q^{II} = q_A^{II} + q_B^{II} \) and \( \bar{\xi} \) denotes \( \bar{\xi}(x_A) := 2(x_A - 2x_B - 2.9). \)

Calculating the derivative \( \frac{\partial \pi_A(x_A, x_B)}{\partial x_A} \) for the case \( 0 < \bar{\xi} < 1, \) we have

\[ \frac{\partial \pi_A(x_A, x_B)}{\partial x_A} = \int_{0}^{\bar{\xi}(x_A)} \frac{\partial}{\partial x_A} \left[ q_A^I p(Q^I, \xi) - c_A(q_A^I) \right] \rho(\xi) d\xi + \int_{\bar{\xi}(x_A)}^{1} \frac{\partial}{\partial x_A} \left[ q_A^{II} p(Q^{II}, \xi) - c_A(q_A^{II}) \right] \rho(\xi) d\xi. \]

Since at the point \( x_A = 2x_B + 2.9 + 0.5\bar{\xi}(x_A), \)

\[ \left( q_A^I(x_A, x_B, \bar{\xi}(x_A)), q_B^I(x_A, x_B, \bar{\xi}(x_A)) \right) = \left( q_A^{II}(x_A, x_B, \bar{\xi}(x_A)), q_B^{II}(x_A, x_B, \bar{\xi}(x_A)) \right). \]

and then \( \frac{\partial \pi_A(x_A, x_B)}{\partial x_A} \) above can be simplified as

\[ \frac{\partial \pi_A(x_A, x_B)}{\partial x_A} = \int_{0}^{\bar{\xi}(x_A)} \frac{\partial}{\partial x_A} \left[ q_A^I p(Q^I, \xi) - c_A(q_A^I) \right] \rho(\xi) d\xi + \int_{\bar{\xi}(x_A)}^{1} \frac{\partial}{\partial x_A} \left[ q_A^{II} p(Q^{II}, \xi) - c_A(q_A^{II}) \right] \rho(\xi) d\xi. \] (4.22)
Moreover, for $\bar{\xi} \geq 1$ and $\bar{\xi} \leq 0$, we have
\[
\frac{\partial \pi_A(x_A, x_B)}{\partial x_A} = \begin{cases} 
\int_0^1 \frac{\partial}{\partial x_A}[q_{AI}p(Q_{II}, \xi) - c_A(q_{AI})] \rho(\xi) d\xi, & \text{if } \bar{\xi} \geq 1; \\
\int_0^1 \frac{\partial}{\partial x_A}[q_{II}p(Q_{II}, \xi) - c_A(q_{II})] \rho(\xi) d\xi, & \text{if } \bar{\xi} \leq 0,
\end{cases}
\tag{4.23}
\]
Combining both (4.22) and (4.23), we can see that $\frac{\partial \pi_A(x_A, x_B)}{\partial x_A}$ is a continuous function of $x_A$ and hence $\pi_A(x_A, x_B)$ is continuously differentiable w.r.t. $x_A$. Repeating the process above on derivative $\frac{\partial \pi_A(x_A, x_B)}{\partial x_A}$, we can show that $\pi_A(x_A, x_B)$ is twice continuously differentiable. This verifies the result in Theorem 4.5.

4.2 Existence of the forward-spot equilibrium

We now move on to discuss the existence of Nash–Cournot equilibrium in the forward-spot market. A well known sufficient condition for the existence is the concavity or quasi-concavity of each generator’s objective function on its strategy space. See for instance Rosen (1965, Theorem 1) and Yuan and Tarafdar (1996, Theorem 1). It turns out, however, very difficult to show this kind of ‘global’ concavity here. For this reason, we look into the local concavity and consequently investigate the existence of ‘local Nash equilibrium’. The notion is used by Hu and Ralph for modeling a bilevel games in an electricity market with locational prices, see Hu and Ralph (2007) for details. As noted in Hu and Ralph (2007), the concept of local Nash equilibrium is proposed as a weaker alternative to Nash equilibrium for the electricity market. From a viewpoint of the real market, given that the global optima of nonconcave maximization problems are difficult to identify, the limitation of knowledge of generators may lead to meaningful local Nash equilibria, in which the local optimality is sufficient for the satisfaction of generators. Moreover, given the condition that the spot market is always profitable for every generator at every scenario $\xi$, we establish our main results on the existence of the global Nash equilibrium in the forward-spot market. We start by giving a definition on local Nash equilibrium.

Definition 4.7 (Local Nash equilibrium) $x^*$ is a local Nash–Cournot equilibrium of the forward market if for each $i$, $x^*_i$ is a local optimal solution to the problem
\[
\max_{x_i \geq 0} \pi_i(x_i, x^*_{-i}) = \mathbb{E}\left[q_i(x_i, x^*_{-i}, \xi)p(Q(x_i, x^*_{-i}, \xi), \xi) - c_i(q_i(x_i, x^*_{-i}, \xi))\right], \quad i = 1, 2, \ldots, M.
\]

Comparing to their global counterparts, local Nash equilibria seem deficient. However, for some decision-making problems, given that global optima are difficult to identify because of the nonconcave objective functions, local optimality may be sufficient for the satisfaction of players. For instance, generators may only optimize their contract positions locally due to limited information on the forward market or general conservativeness. To illustrate the existence of the local Nash–Cournot equilibrium in the forward-spot market, we present the following example based on the duopoly model in Example 3.8.
Example 4.8  (Continued from Example 4.6) Consider a duopoly market described in Example 4.6, in which the capacity limits of generator $A$ and $B$ are $q_A^u = 3.6$ and $q_B^u = 3.5$, respectively.

Define

$$X = \{(x_A, x_B) \mid x_A > 0.4, \ x_B > 0.6\},$$

and $x := (x_A, x_B) \in X$. Let

$$X^+ = \{x = (x_A, x_B) \mid q_A(x, \xi) > 0, \ q_B(x, \xi) > 0, \ \forall \xi \in [0, 1]\}.$$ That is, if contract position $x = (x_A, x_B)$ is in $X^+$, then for all $\xi \in \Xi$, the dispatch of each generator in the spot market is always strictly positive. It is easy to verify that $X^+$ is an open convex set.

Let $x \in X \cap X^+$ (the set $X \cap X^+$ is nonempty, open and convex). It is easy to derive that the optimal dispatches in the spot market satisfy the following:

$$q_A(x, \xi) = \frac{1}{4}(6.2 - 2q_B(x, \xi) + \xi + 2x_A),$$

$$q_B(x, \xi) = \frac{1}{4}(6 - 2q_A(x, \xi) + \xi + 2x_B),$$

$$q_A(x, \xi) > 0, \ \text{for all} \ \xi \in \Xi,$$

$$q_B(x, \xi) > 0, \ \text{for all} \ \xi \in \Xi,$$

and the spot price is

$$p(q_A + q_B, \xi) = 7 + \xi - 2(q_A + q_B)$$

$$= \frac{1}{3}(8.8 + \xi - 2x_A - 2x_B).$$

Consequently, we have the generators’ profit functions in the forward market

$$\pi_A(x_A, x_B) = \int_{\xi=0}^{1} [q_A p - c_A(q_A)] \rho(\xi) d\xi$$

$$= \frac{1}{18} \left[ \frac{1}{3} + \frac{1}{2}(12.8 + 2x_A - 4x_B) \right.$$

$$+ (6.4 + 4x_A - 2x_B)(6.4 - 2x_A - 2x_B) \left. \right],$$

$$\pi_B(x_B, x_A) = \int_{\xi=0}^{1} [q_B p - c_B(q_B)] \rho(\xi) d\xi$$

$$= \frac{1}{18} \left[ \frac{1}{3} + \frac{1}{2}(11.6 + 2x_B - 4x_A) \right.$$

$$+ (5.8 + 4x_B - 2x_A)(5.8 - 2x_A - 2x_B) \left. \right].$$
Accordingly, the first order derivative of \( \pi \) w.r.t. \( x_i \), \( i = A, B \), are

\[
\frac{\partial \pi_A}{\partial x_A} = \frac{1}{18} (13.8 - 16x_A - 4x_B),
\]
\[
\frac{\partial \pi_B}{\partial x_B} = \frac{1}{18} (11.6 - 16x_A - 4x_B).
\]

By solving the system of equations

\[
\frac{1}{18} (13.8 - 16x_A - 4x_B) = 0,
\]
\[
\frac{1}{18} (11.6 - 16x_A - 4x_B) = 0,
\]

we obtain \( x^* = (x_A^*, x_B^*) = (0.71, 0.61) \). It is easy to verify that \( x^* \in X^+ \cap X \).

Moreover, since

\[
\frac{\partial^2 \pi_A(x^*)}{\partial x_A^2} = -\frac{8}{9},
\]
\[
\frac{\partial^2 \pi_B(x^*)}{\partial x_B^2} = -\frac{8}{9},
\]

then the expected profit functions are concave. Therefore \( x^* \) is a local Nash–Cournot equilibrium.

Before presenting further analysis on the existence of local Nash equilibrium, we need the following result on the concavity of each generator’s dispatch function.

**Proposition 4.9** Let \( p(Q, \xi) = \alpha(\xi) - \beta(\xi)Q \), where \( \xi : \Omega \to \Xi \subset \mathbb{R} \) is a random variable defined on probability space \((\Omega, \mathcal{F}, P)\), \( \alpha(\xi) : \Xi \to \mathbb{R}_+ \) and \( \beta(\xi) : \Xi \to \mathbb{R}_+ \) are continuous functions for all \( \xi \in \Xi \). Assume that the marginal cost functions \( c_i(q_i) \), \( i = 1, \ldots, M \), satisfy one of the following conditions:

(i) \( c_j(q_j) \) is linear on \( q_j \in [0, q_j^u] \) for \( j = 1, \ldots, M \);
(ii) all generators’ marginal cost functions are identical and nondecreasing, that is, for any \( \bar{q} > 0 \)

\[
c_1'(\bar{q}) = c_2'(\bar{q}) = \cdots = c_M'(\bar{q}).
\]

Under Assumptions 2.1, 2.2, 2.6, and 3.6, the aggregate dispatch quantity \( Q(x, \xi) \) is convex w.r.t. \( x_i \) for \( x_i \geq 0 \).

The proof of this proposition is attached in the appendix of this paper. The proof not only shows the convexity of the aggregate dispatch quantity, but also gives the formulation of \( Q'_{x_i}(x, \xi) \) in (6.47), which implies that the more contract is signed, the higher rate of increase in the aggregate dispatch is. It also shows that the rate of increase is a piecewise smooth function of \( x \) for any \( \xi \).
Lemma 4.10 Under Assumptions 2.1, 2.2, 2.6, and 3.6, for fixed $x_{-i}$ and $\xi \in \Xi$, the function $p(Q(x, \xi), \xi) - c'_i(q_i(x_i, x_{-i}, \xi))$ is a decreasing function w.r.t. $x_i$.

Proof Let

$$h(x_i, x_{-i}, \xi) := p(Q(x, \xi), \xi) - c'_i(q_i(x_i, x_{-i}, \xi)).$$

Under the assumption of Proposition 4.9, we have

$$h(x_i, x_{-i}, \xi) = \alpha(\xi) - \beta(\xi) Q(x, \xi) - c'_i(q_i(x_i, x_{-i}, \xi)).$$

For each fixed $\xi \in \Xi$,

$$\partial_x h(x_i, x_{-i}, \xi) \subset -\beta(\xi) \partial_x Q(x, \xi) - c''_i(q_i(x_i, x_{-i}, \xi)) \partial_x q_i(x_i, x_{-i}, \xi).$$

By Proposition 3.7 and Assumption 2.2, $\partial_x Q(x, \xi) \subset [0, 1)$, $\partial_x q_i(x_i, x_{-i}, \xi) \subset [0, 1)$ and $c''(q_i) \geq 0$. Thus

$$\partial_x h(x_i, x_{-i}, \xi) \subset -\beta(\xi) \partial_x Q(x, \xi) - c''_i q_i(x_i, x_{-i}, \xi) \subset (-\infty, 0],$$

which implies that $p(Q(x, \xi), \xi) - c'(q_i(x_i, x_{-i}, \xi))$ is a decreasing function of $x_i$ for every $\xi$.

We are now ready to state a couple of existence results on equilibrium in the forward-spot market. Before that, we define the index set $\mathcal{I}(x, \xi) = \{j | q_j(x, \xi) \geq 0\}$ which is slightly different from the definition of $\mathcal{I}(x_i, \xi) = \{j | q_j(x_i, x_{-i}, \xi) \geq 0, \ j \neq i\}$ for fixed $x_{-i}$ in the proof of Proposition 4.9.

Theorem 4.11 (Existence of local equilibrium) Let assumptions in Proposition 4.9 hold. There exists at least one local Nash–Cournot equilibrium in the forward market, if the following conditions are satisfied:

1. There exist open and convex sets $X_i, i = 1, \ldots, M$, such that for any $\xi \in \Xi$, $\mathcal{I}(x, \xi)$ is constant on $X := X_1 \times X_2 \times \cdots \times X_M$.
2. For $i = 1, 2, \ldots, M$, there exist a non-empty compact convex subset $X^0_i$ of $X_i$ and a non-empty compact subset $K_i$ of $X_i$ such that, for each $x \in X \setminus K$, there exists $y \in \text{conv}(X^0 \cup \{x\})$ satisfying

$$\sum_{i=1}^{M} \pi_i(x_i, x_{-i}) < \sum_{i=1}^{M} \pi_i(y_i, x_{-i}),$$

where $X^0 := \prod_{i=1}^{M} X^0_i$ and $K := \prod_{i=1}^{M} K_i$.

Proof We first consider a local forward-spot equilibrium problem formulated as

$$\begin{align*}
\{ \pi_i(x_i^*, x_{-i}^*) = \max_{x_i \in X_i} \pi_i(x_i, x_{-i}), \\
q_i^*(x^*, \xi) \in \arg\max_{q_i \geq 0} R_i(q_i(x^*, \xi), x^*, Q_{-i}(x^*, \xi), \xi), \quad \forall \xi \in \Xi, \hspace{1cm} (4.25)\end{align*}$$
for $i = 1, 2, \ldots, M$, where $(q_1(x^*, \xi), \ldots, q_M(x^*, \xi))$ is the global Nash–Cournot equilibrium in the spot market for fixed $x^*$. Note that, in this local equilibrium problem, the decision variables $x_i$ for $i = 1, 2, \ldots, M$ take their values in a noncompact and convex subset $X_i$ of the feasible strategy set $[0, +\infty)$ in the global problem (2.7).

Let

$$f_i(x_i, x_{-i}, \xi) := q_i^*(x_i, x_{-i}, \xi) p(Q^*(x, \xi), \xi) - c_i(q_i^*(x_i, x_{-i}, \xi)).$$

(4.26)

We reformulate (4.25) as

$$\max_{x_i \in X_i} \pi_i(x_i, x_{-i}) = E[f_i(x_i, x_{-i}, \xi)].$$

(4.27)

We prove the existence of a local Nash–Cournot equilibrium satisfying (4.27) by virtue of Yuan and Tarafdar (1996, Theorem 1) which addresses the existence of Nash equilibrium problem with noncompact feasible sets of strategies.

To apply this theorem, we need to verify Conditions (1) to (4) in Yuan and Tarafdar (1996, Theorem 1) Conditions (1) and (2) in Yuan and Tarafdar (1996, Theorem 1) can be easily verified by the twice continuously differentiability of $\pi_i(x_i, x_{-i})$ proved in Theorem 4.5. Condition (4) in Yuan and Tarafdar (1996, Theorem 1) is equivalent to Condition (2) of Theorem 4.11.

To verify Condition (3), we need to show that $f_i$ is concave w.r.t. $x_i$ on the non-compact feasible set $X_i$ for every fixed $\xi$. For this purpose, we need to prove that the right-hand derivative of $f_i(x_i, x_{-i}, \xi)$ is a non-increasing function of $x_i$ on $X_i$. Denote the right-hand derivative of $f_i(x_i, x_{-i}, \xi)$ by $f_i^+(x_i, x_{-i}, \xi)$. Then

$$f_i^+(x_i, x_{-i}, \xi) = q_i^+(x_i, x_{-i}, \xi)[p(Q(x, \xi), \xi) - c'_i(q_i(x_i, x_{-i}, \xi))]$$

$$-q_i(x_i, x_{-i}, \xi)\beta(\xi)Q_i^+(x, \xi).$$

Similar to the proof of Proposition 4.9 and Lemma 4.10, we divide the right-hand derivative of $f_i(x_i, x_{-i}, \xi)$ w.r.t. $x_i$ into two cases depending on whether $i \in I(x, \xi)$ or not. Case 1, $i \in I(x, \xi)$. We have

$$f_i^+(x_i, x_{-i}, \xi) = \frac{1 + |I(x, \xi)|}{2 + |I(x, \xi)|}[p(Q(x, \xi), \xi) - c'_i(q_i(x_i, x_{-i}, \xi))]$$

$$-\frac{1}{2 + |I(x, \xi)|}q_i(x_i, x_{-i}, \xi)\beta(\xi).$$

Case 2, $i \not\in I(x, \xi)$. We have

$$f_i^+(x_i, x_{-i}, \xi) = -\frac{1}{2 + |I(x, \xi)|}q_i(x_i, x_{-i}, \xi)\beta(\xi).$$

Because $|I(x, \xi)|$ is constant on $X_i$, $q_i(x, \xi)$ is a monotonically increasing function of $x_i$ and $p(Q(x, \xi), \xi) - c'_i(q_i(x_i, x_{-i}, \xi))$ is decreasing by Lemma 4.10, we can easily see that $f_i^+(x_i, x_{-i}, \xi)$ is a decreasing function of $x_i$ in either case. This shows
the concavity of \( f_i(x_i, x_{-i}, \xi) \) and hence of \( \pi_i(x_i, x_{-i}) = \mathbb{E}[f_i(x_i, x_{-i}, \xi)] \) on the set \( X = \prod_{i=1}^{M} X_i \), because concavity is preserved under the integration w.r.t. \( \xi \), which verifies Condition (3) in Yuan and Tarafdar (1996, Theorem 1).

Therefore, Yuan and Tarafdar (1996, Theorem 1), there exists at least one Nash–Cournot equilibrium for \( \{4.27\} \) for \( i = 1, 2, \ldots, M \). Let us denote the equilibrium by \( x^* = (x_1^*, x_2^*, \ldots, x_M^*)^T \). Since, for every \( i = 1, 2, \ldots, M \), \( X_i \) is an open subset of \([0, +\infty)\), then \( x_i^* \) is a local maximizer of \( \pi_i(x_i, x_{-i}^*) \) for \( x_i \geq 0 \). Hence, \( x^* \) is also a local Nash–Cournot equilibrium for the global equilibrium problem

\[
\max_{x_i \geq 0} \pi_i(x_i, x_{-i}^*) = \mathbb{E}[f_i(x_i, x_{-i}, \xi)], \quad i = 1, 2, \ldots, M.
\]

By Proposition 3.3, there exists a unique equilibrium \( q(x^*, \xi) = (q_1(x^*, \xi), \ldots, q_M(x^*, \xi)) \) for the game problem in the spot market given that generators reach the local equilibrium \( x^* \) in the forward market. Therefore, 2M tuple \( (x_1^*, x_2^*, \ldots, x_M^*, q_1(x^*, \xi), \ldots, q_M(x^*, \xi)) \) is a local Nash–Cournot equilibrium for the forward-spot competition problem,

\[
\begin{align*}
\pi_i(x_i^*, x_{-i}^*) &= \max_{x_i \geq 0} \pi_i(x_i, x_{-i}), \\
q_i^*(x^*, \xi) &= \arg \max_{q_i \geq 0} R_i(q_i(x^*, \xi), x^*, Q_{-i}(x^*, \xi), \xi), \quad i = 1, 2, \ldots, M, \quad \forall \xi \in \Xi,
\end{align*}
\]

(4.28)

This completes the proof. \( \square \)

From a practical perspective, Theorem 4.11, giving a result on the existence of local Nash equilibrium, implies that, if every generator would like to accept a local optimal solution subject to its limited knowledge of the nonconcave profit function, then all generators will reach an equilibrium in the forward-spot market. On the other hand, the restrictions of Theorem 4.11 are straightforward. First, the theorem only gives a result on the existence of local Nash equilibrium which is not necessarily an optimal choice for each generator. Second, Condition (2) in Theorem 4.11 on the structure of the feasible sets may not be easily verified in the real system because it is given purely for a mathematical purpose. In order to get a result with more practical implication, we need to consider a particular type of markets in which every generator is profitable for every demand scenario. In the following theorem, we will show the existence of the global Nash–Cournot equilibrium for a class of forward-spot markets.

**Theorem 4.12** (Existence of global equilibrium) Let conditions in Proposition 4.9 hold. If for any contracts \( x := (x_1, \ldots, x_M) \) signed in the forward market, the spot equilibrium \( (q_1(x, \xi), \ldots, q_M(x, \xi)) \) satisfies the condition that for any scenario \( \xi \in \Xi \),

\[
p(Q(x, \xi), \xi) - c_i'(q_i(x, \xi)) + \beta(\xi)q_i(x, \xi) > 0, \quad (4.29)
\]

for \( i = 1, 2, \ldots, M \), then there exists a global Nash–Cournot equilibrium in the forward-spot market.
Remark 4.13 We make a few comments on the condition (4.29) before providing a proof.

(i) The condition implies that every generator makes a positive dispatch in the spot equilibrium for any $x \in X$ and $\xi \in \Xi$. To see this, let us assume for a contradiction that there exists $i$ such that $q_i(x, \xi) = 0$ in the spot equilibrium. From the condition (4.29), we have $p(Q_{-i}(x, \xi), \xi) - c'_i(0) > 0$. Therefore, from the continuity of functions $p(\cdot, \xi)$ and $c'_i(\cdot)$, there exists a small positive value $\epsilon$ satisfying that $p(\epsilon + Q_{-i}(x, \xi), \xi) - c'_i(\epsilon) > 0$ and hence generator $i$’s profit function $R_i(\epsilon, x, Q_{-i}, \xi)$ in the spot market can be calculated as

$$R_i(\epsilon, x, Q_{-i}, \xi) = (\epsilon - x_i)p(\epsilon + Q_{-i}(x, \xi), \xi) - c_i(\epsilon)$$

$$= (\epsilon - x_i)p(\epsilon + Q_{-i}(x, \xi), \xi) - \left( \int_0^\epsilon c'_i(q) dq + c_i(0) \right)$$

$$> (\epsilon - x_i)p(\epsilon + Q_{-i}(x, \xi), \xi) - (c'_i(\epsilon) + c_i(0))$$

$$> -x_i p(\epsilon + Q_{-i}(x, \xi), \xi) - c_i(0),$$  \hspace{1cm} (4.30)

where the first inequality is from the convexity of $c_i(\cdot)$ assumed in (iii) of Proposition 2.2. Consequently, we have

$$R_i(\epsilon, x, Q_{-i}, \xi) > -x_i p(\epsilon + Q_{-i}(x, \xi), \xi) - c_i(0)$$

$$> (0 - x_i)p(Q_{-i}(x, \xi), \xi) - c_i(0)$$

$$= R_i(0, x, Q_{-i}, \xi),$$  \hspace{1cm} (4.31)

which implies that $q_i = 0$ is not the optimal decision of generator $i$ given its rivals’ decision $q_{-i}(x, \xi)$ in the spot equilibrium, hence $(0, q_{-i}(x, \xi))$ is not an equilibrium, a contradiction! Therefore, for any fixed $x_{-i}, i \in I(x, \xi)$.

(ii) Theorem 4.12 may be viewed as a special case of Theorem 4.11 on local Nash equilibrium. Since $q_i(x, \xi) > 0$ for generator $i$ in the spot equilibrium, we have that every generator dispatches a positive quantity, and hence $I(x, \xi) = \{1, 2, \ldots, M\}$ is constant in the whole strategy space, which satisfies condition (i) of Theorem 4.11. From the proof of Theorem 4.12, we can identify the concavity of generator $i$’s profit function in the whole strategy space $X$, and hence condition (2) is also satisfied. Therefore, the condition in Theorem 4.12 implies both conditions in Theorem 4.11.

Proof of Theorem 4.12 Under the assumption $p(Q, \xi) = \alpha(\xi) - \beta(\xi)Q$ in Proposition 4.9, we have

$$p(Q_{-i}(x, \xi), \xi) - c'_i(q_i(x, \xi)) = \alpha(\xi) - \beta(\xi)Q_{-i}(x, \xi) - c'_i(q_i(x, \xi)) \geq 0,$$  \hspace{1cm} (4.32)

for all $\xi \in \Xi$. 

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Now, we look into the right-hand derivative of $f_i(x_i, x_{-i}, \xi)$, which can be written as following,

$$f_i^+(x_i, x_{-i}, \xi) = q_i^+(x_i, x_{-i}, \xi) \left[ p(Q(x_i, x_{-i}, \xi), \xi) - c'_i(q_i(x_i, x_{-i}, \xi)) \right] - q_i(x_i, x_{-i}, \xi) \beta(\xi) Q_{x_i}^+(x, \xi).$$

(4.33)

By (4.30), we have that every generator will dispatch a positive quantity and hence $i \in \mathcal{I}(x, \xi)$ for every generator $i$ and any fixed contract quantity $x$. From the proof of Proposition 4.9, we can reformulate (4.33) as

$$f_i^+(x_i, x_{-i}, \xi) = \frac{1 + |\mathcal{I}(x_i, x_{-i}, \xi)|}{2 + |\mathcal{I}(x_i, x_{-i}, \xi)|} \left[ p(Q(x, \xi), \xi) - c'_i(q_i(x_i, x_{-i}, \xi)) \right] - \frac{1}{2 + |\mathcal{I}(x_i, x_{-i}, \xi)|} q_i(x_i, x_{-i}, \xi) \beta(\xi),$$

where we reformulate $\mathcal{I}(x, \xi)$ by $\mathcal{I}(x_i, x_{-i}, \xi)$ to emphasize generator $i$’s decision. As proved in Sect. 3, $q_i(x_i, x_{-i}, \xi)$ and hence $f_i^+(x_i, x_{-i}, \xi)$ are piecewise smooth functions of $x_j$ for any $i, j = 1, 2, \ldots, M$. For any fixed $x_{-i}$, we proceed the proof by dividing our discussion on the monotonicity of the right-hand derivative of $f_i(x_i, x_{-i}, \xi)$ in two cases depending on the smoothness of $f_i$:

Case 1, we consider the monotonicity of $f_i^+(x_i, x_{-i}, \xi)$ at the point $x_i$ where the set $\mathcal{I}(x_i, x_{-i}, \xi)$ is constant and hence $f_i^+(x_i, x_{-i}, \xi)$ is continuous. From Lemma 4.10, $p(Q(x, \xi), \xi) - c'_i(q_i(x_i, x_{-i}, \xi))$ is a decreasing function of $x_i$ for any fixed $x_{-i}$, and $q_i(x_i, x_{-i}, \xi)$ is an increasing function of $x_i$. Therefore, we have $f_i^+(x_i, x_{-i}, \xi)$ is a decreasing function of $x_i$ for any fixed $x_{-i}$ and any scenario $\xi$ in every smooth piece of $x_i$.

Case 2, we consider the monotonicity of $f_i^+(x_i, x_{-i}, \xi)$ at the point $x_i$ where $\mathcal{I}(x_i, \xi)$ is not constant and hence $f_i^+(x_i, x_{-i}, \xi)$ is not continuous. Let

$$x_i^- = \lim_{\delta \to 0} x_i - \delta, \quad \text{and} \quad x_i^+ = \lim_{\delta \to 0} x_i + \delta, \quad \text{for a} \ \delta > 0,$$

which are on the left and right sides of $x_i$, respectively. Since $|\mathcal{I}(x, \xi)|$ is a decreasing function of $x_i$ for any fixed $x_{-i}$ which has been shown in the proof of Proposition 4.9, we have $I^+ := |\mathcal{I}(x_i^+, x_{-i}, \xi)|$ is less than or equal to $I^- := |\mathcal{I}(x_i^-, x_{-i}, \xi)|$ for every fixed $x_{-i}$ and $\xi$. Moreover, because of the Lipschitz continuity of $q_i(x_i(x_i^+, x_{-i}, \xi))$ w.r.t $x_j$ for any $i, j = 1, 2, \ldots, M$, we have $q_i(x_i^+, x_{-i}, \xi) = q_i(x_i^-, x_{-i}, \xi) = q_i(x_i, x_{-i}, \xi)$ for any $x_{-i}$, and hence

$$f_i^+(x_i^+, x_{-i}, \xi) - f_i^+(x_i^-, x_{-i}, \xi) = \left[ \frac{1 + I^+}{2 + I^+} \left[ p(Q, \xi) - c'_i(q_i) \right] - \frac{1}{2 + I^+} q_i \beta(\xi) \right].$$
\[-\left\{ \frac{1 + I^-}{2 + I^-} [p(Q, \xi) - c'_i(q_i)] - \frac{1}{2 + I^-} q_i \beta(\xi) \right\} \]

\[= \frac{1}{(2 + I^+)(2 + I^-)} \left[ (I^+ - I^-) (p(Q, \xi) - c'_i(q_i) + q_i \beta(\xi)) \right] , \]

where the second equality is from \( q_i(x_i^+, x_{-i}, \xi) = q_i(x_i^-, x_{-i}, \xi) \). Due to (4.29) in this theorem, we have

\[ f_i^+(x_i^+, x_{-i}, \xi) - f_i^-(x_i^-, x_{-i}, \xi) \]

\[= \frac{1}{(2 + I^+)(2 + I^-)} \left[ (I^+ - I^-) (p(Q, \xi) - c'_i(q_i) + q_i \beta(\xi)) \right] < 0, \]

which means that, at the point \( x_i \), \( f_i^+(x_i, x_{-i}, \xi) \) is also a decreasing function of \( x_i \) for fixed \( x_{-i} \).

By combining the results in both cases, we can show that the right-hand derivative of \( f_i(x_i, x_{-i}, \xi) \) is a decreasing function of \( x_i \) for \( i = 1, 2, \ldots, M \), which indicates that the function \( f_i(x_i, x_{-i}, \xi) \) and hence \( \pi_i(x_i, x_{-i}) \) are concave functions of \( x_i \). From the proof of Rosen (1965, Theorem 1), we know that there exists a global Nash–Cournot equilibrium in the forward-spot market.

From Theorem 4.12 and Remark 4.13, we can make the following qualitative statement.

**Corollary 4.14** If for all possible demand shock, every generator makes a positive dispatch in the spot equilibrium, then there exists a global Nash–Cournot equilibrium in the forward-spot electricity market.

### 5 Numerical examples

In this section, we present a simple example to illustrate how the forward-spot market equilibrium can be obtained numerically and how the SEPEC model can be used to analyze the interaction of the markets. We carry out some computer simulations for the SEPEC model with two players. We investigate how the dispatches, expected profits and strike prices vary on the change of a generator’s contract position.

Note that it is very difficult to obtain a closed form of the expected value of the objective functions. Consequently, we use a well known sample average approximation (SAA) approach to approximate the expected values. SAA is a popular method in stochastic programming; see Gurkan et al. (1999), Robinson (1996), DeMiguel and Xu (2008) and the references therein. The basic idea behind the SAA method is to approximate the expected value function by a sample average. Here we use the SAA approach as in DeMiguel and Xu (2008) to solve our SEPEC problem. We skip the theoretical analysis of convergence of this method because we believe similar conclusion can be drawn as in DeMiguel and Xu (2008) and it is not the focus of this paper.

We now move on to computer simulations for the SEPEC model to look into specifically dependence of dispatches, expected profits and strike prices on forward contracts.
Let $\xi^1, \ldots, \xi^N$ be an independent identically distributed (i.i.d) sample of $\xi(\omega)$, where $N$ is the sample size. The sample average approximation problem for generator $i$ is,

$$\max_{x_i \geq 0} \frac{1}{N} \sum_{k=1}^{N} q_i^N(x, \xi^k)p(Q^N(x, \xi^k), \xi^k) - c_i(q_i^N(x, \xi^k)), \quad (5.34)$$

where for $i = 1, 2, \ldots, M$, $q_i^N(x, \xi^k)$ is defined implicitly as the equilibrium in the spot market at demand scenario $\xi^k$, and $Q^N(x, \xi^k) = \sum_{i=1}^{M} q_i^N(x, \xi^k)$. Note that as discussed in Sect. 3.2, $q^N(x, \xi^k) = (q_1^N(x, \xi^k), \ldots, q_M^N(x, \xi^k))^T$ is a solution to the nonlinear complementarity problem $0 \leq q^N(x, \xi^k) \perp G(x, q^N, \xi^k) \geq 0$, where

$$G(x, q^N, \xi^k) = -p(Q^N(x, \xi^k), \xi^k)e - (q^N - x)p'(Q^N(x, \xi^k), \xi^k) + \nabla c(q^N).$$

Consequently the problem can be reformulated as the following standard nonlinear programming problem:

$$\max_{x_i \geq 0} \frac{1}{N} \sum_{k=1}^{N} q_i^N(x, \xi^k)p(Q^N(x, \xi^k), \xi^k) - c_i(q_i^N(x, \xi^k)) \quad \text{s.t.} \quad q^N \geq 0 \quad \forall k,$$

$$G(x, q^N, \xi^k) \geq 0 \quad \forall k,$$

$$-q^N \circ G(x, q^N, \xi^k) \geq 0 \quad \forall k,$$

where $\circ$ represents the componentwise scalar product.

**Example 5.1** Consider two generators, $A$ and $B$, competing in a forward market. Assume that the inverse demand function takes the following form

$$p(Q, \xi) = \alpha(\xi) - \beta(\xi)Q,$$

where $\xi$ is a random variable following a truncated normal distribution with zero mean, standard deviation of 1, and truncated at two deviations above and below the mean. Let $\alpha(\xi) = 2 + \xi$, $\beta(\xi) = 7 + 0.5\xi$, and each generator’s cost function be as follows:

Generator $A$ : $c_A(q_A) = 0.1q_A^2 + 1q_A$;

Generator $B$ : $c_B(q_B) = 0.1q_B^2 + 0.5q_B$.

By fixing the Generator $A$’s contract level $x_A$, we carry out some static analysis on generator’s dispatch $q_i$, for $i = A$ and $B$, expected profit $\pi_B(x_A, x_B)$ and market clearing price $p(Q, \xi)$ in the spot market, w.r.t. the different values of $x_B$.

In Figs. 1 and 2, we let $x_A = 0$, that is, generator $A$ has no contract. We examine how the optimal dispatch of $A$ varies as $x_B$ increases. The results show that generator $A$’s average dispatch decreases as $x_B$ increases from 0 to 0.1, and it becomes zero when $x_B \in [0.1, 0.3]$. This demonstrates that generator $A$’s dispatch is a decreasing function of $x_B$. The results also show that generator $B$’s average dispatch $q_B$ increases as $x_B$ increases and the curve of $q_B$ is concave.
In Fig. 2, we show that the strike price is a piecewise smooth and decreasing function of $x_B$. Moreover, because $z(x_A + x_B) = \mathbb{E}[\alpha(\xi) - \beta(\xi)Q(x, \xi)]$, and $Q(x, \xi)$ is a convex function of $x_B$, the strike price is a concave function of $x_B$.

In Fig. 3, we present some results on the expected profits of generator $B$, that is $\pi_B(x_A, x_B)$, for various contracts $x_A$ and $x_B$. We observe that there is a local maximizer of $\pi_B(x_A, x_B)$ w.r.t. $x_B \in [0, 0.2]$ for every fixed $x_A$. The underlying reason...
of the results is that by signing more contracts, generator B becomes more incentives
to dispatch in the spot market as we have shown in Fig. 1. On the other hand, more
contracts result in a lower average spot price and hence contract strike price. Conse-
quently, it results in a lower expected profit for generator B shown in Fig. 3. For its
rival, because a greater contract quantity from B leads to a lower average price in the
spot market, generator A will lose its profit.

6 Further discussion

In this paper, we have developed an SEPEC model for studying interactions between
the forward market and the spot market. The model is essentially an extension of a
Nash–Cournot model developed by Gans et al. (1998) for deterministic duopolistic
electricity markets. A number of restrictions have been made to simplify the discus-
sions: (a) the spot market competition is assumed to take place in a single node where
the network constraints and transmission costs are not considered; (b) one-way con-
tacts such as call options and put options, are not considered; (c) there is no speculator
in the forward market; (d) bids in spot market is a single quantity rather than a stack of
prices and quantities as in supply function models. We believe that similar equilibrium
results can be established by dropping some of the restrictions although we have not
attempted. We leave this for our future work.

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Appendix

Proof of Lemma 3.1 Part (i) is proved in Proposition 2.4, Xu (2005).

Part (ii). By differentiating the function \( R(Q, \xi) = (Q - X)p(Q + K, \xi) \), we have

\[
R'_Q(Q, \xi) = p(Q + K, \xi) + (Q - X)p'_Q(Q + K, \xi).
\]

Consequently,

\[
R''_Q(Q, \xi) = 2p'_Q(Q + K, \xi) + (Q - X)p''_Q(Q + K, \xi) \leq p'_Q(Q + K, \xi) - Xp''_Q(Q + K, \xi).
\]

From Assumption 2.2 (a) and (b), we have

\[
R''_Q(Q, \xi) \leq p'_Q(Q + K, \xi) - Xp''_Q(Q + K, \xi) < 0.
\]

Therefore, the function \((Q - X)p(Q + K, \xi)\) is strictly concave. \(\square\)

Proof of Theorem 3.5 Part (i). The Jacobian of \( G(q, x, \xi) \) w.r.t. \( q \) can be written explicitly as

\[
\nabla_q G(q, x, \xi) = -p'_Q(Q, \xi)ee^T - p''_Q(Q, \xi)(q - x)e^T - p'_Q(Q, \xi)IM + \nabla^2 c(q)
\]

where \( Q = q^T e \) is the aggregated supply quantity and \( IM \in \mathbb{R}^{M \times M} \) is an identity matrix. Since \( p(Q, \xi) \) is strictly decreasing in \( q_i \), we have \( p'_Q(Q, \xi) < 0 \) for any \( Q \geq 0, \xi \in \Xi \). Moreover, because the terms \(-p'_Q(Q, \xi)ee^T \) and \(-p''_Q(Q, \xi)(q - x)e^T \) are both rank one matrices, and \(-p'_Q(Q, \xi)IM \) and \( \nabla^2 c(q) \) are both diagonal matrices, the eigenvalues of \( \nabla_q G(q, x, \xi) \) are lower bounded by

\[
-Mp'_Q(Q, \xi) - p''_Q(Q, \xi)(q - x)^T e + \min_{i=1,...,M} c''_i(q_i) - p'_Q(Q, \xi). \tag{6.36}
\]

Since \( \Xi \) is compact, there exists a constant \( C > 0 \) such that

\[
\min_{\xi \in \Xi} -p'_Q(Q, \xi) \geq C, \text{ for } Q \in \left[ 0, \sum_{i=1}^{M} q_i^u \right].
\]

On the other hand, from the convexity of \( p(Q, \xi) \) and Assumption 2.2 (ii), we have

\[
-Mp'_Q(Q, \xi) - p''_Q(Q, \xi)(q - x)^T e = -p'_Q(Q, \xi) - p''_Q(Q, \xi)q^T e + p''_Q(Q, \xi)x^T e \geq 0. \tag{6.37}
\]

By the convexity of cost function under Assumption 2.2 (iii), \( c''_i(q_i) \geq 0 \), for any \( q_i \geq 0, \xi \in \Xi \). Substituting (6.37) into (6.36), we have

\[
-(M + 1)p'_q(q, \xi) - p''_q(q, \xi) + \min_{i=1,...,M} c''_i(q_i) \geq MC,
\]
which implies that $\nabla_q G(q, x, \xi)$ is uniformly positive definite. We now consider (3.11). It can be easily found that function $F(q, x, \xi)$ is Lipschitz continuous and the Clarke generalized Jacobian of $F$ in $(q, x, \xi)$ can be written as

$$\partial F(q, x, \xi) = \left( I_M - \Theta \Theta \right) \left( \frac{I_M}{\nabla_q G(q, x, \xi)} \right) : \theta_i \in [0, 1], i = 1, 2, \ldots, M \right).$$

(6.38)

and

$$\partial_q F(q, x, \xi) = \Theta \nabla_q G(q, x, \xi) + (I_M - \Theta),$$

where $\Theta := \text{diag}(\theta_1, \ldots, \theta_M) \in \mathbb{R}^{M \times M}$, is a diagonal matrix with the $(i, i)$th entry being $\theta_i$, for $i = 1, 2, \ldots, M$. Thus, by Lemma 3.1 in Xu (2005), $\nabla_q F(q, x, \xi)$ is uniformly non-singular.

Part (ii). The conclusion follows straightforwardly from uniqueness and existence of the Nash–Cournot equilibrium in the spot market in Proposition 3.3 together with the definition of the nonsmooth function $F$.

Part (iii). From Part (i), $\nabla_q F(q, x, \xi)$ is non-singular. By the proof of Part (ii) and Lemma 3.2 in Xu (2005), there exists a unique Lipschitz continuous and piecewise smooth implicit function $q(x, \xi)$, such that $F(q(x, \xi), x, \xi) = 0$ in a neighborhood of $(q, \xi)$. The domain of implicit function can be extended to $[0, +\infty) \times \Xi$ given the non-singularity of $\nabla_q F(q, x, \xi)$ for all $x, \xi$ and the existence and uniqueness in Proposition 3.3.

Proof of Proposition 3.7 Part (i). The conclusion follows from Xu and Meng (2007, Lemma 2.1) because $F$ is piecewise smooth in $q$.

Part (ii). Since $\partial_x Q(x, \xi) \subset e^T \partial_x q(x, \xi)$, we have from (3.13)

$$\partial_x Q(x, \xi) \subset e^T \text{conv} \{- W^{-1} U : (W, U, V) \in \partial F(q, x, \xi)\}.$$ 

Since, for $i = 1, 2, \ldots, M$, the $i$th component of $F(q, x, \xi)$, $F_i$, is a piecewise smooth function, the Clarke subdifferential of $F_i(q, x, \xi)$ can be written as

$$\partial_{(q, x)} F_i(q, x, \xi) = \{ \theta_i \nabla G_i(q, x, \xi) + (1 - \theta_i) I_i \},$$

where $\theta_i \in [0, 1]$, $G_i(\cdot)$ is the $i$th component of function $G(\cdot)$ and $I_i$ is a 2$M + 1$ dimensional vector with the $i$th component being 1 and the rest being zero.

Note that $\theta_i = 0$ only when $F_i(q, x, \xi) = q_i$. Let $\Theta = \text{diag}(\theta_1, \ldots, \theta_M)$. First, we show that under condition (3.12), $q(x, \xi) \neq 0$. Let $i_0 \in \{1, \ldots, M\}$ be such that

$$c_{i_0}'(0) < p(Q(x, \xi), \xi), \quad \xi \in \Xi.$$

(6.39)

By definition, $q_{i_0}(x, \xi)$ solves the following maximization problem

$$\max_{q_{i_0} \geq 0} R_{i_0}(q_{i_0}, x, Q_{-i_0}, \xi) = q_{i_0} p \left( q_{i_0} + Q_{-i_0}, \xi \right) - c_{i_0}(q_{i_0}) - x_{i_0} \left[ p(q_{i_0} + Q_{-i_0}, \xi) - \bar{z} \right].$$
The first-order necessary condition can be represented as the following complementarity conditions:

\[
q_{i_0}(x, \xi) \frac{dR_{i_0}(q_{i_0}, x, Q_{-i_0}, \xi)}{dq_{i_0}} = q_{i_0}(x, \xi) \left[ p(Q(x, \xi), \xi) + (q_{i_0} - x_{i_0})p'_Q(Q(x, \xi), \xi) - c'_{i_0}(q_{i_0}(x, \xi)) \right] = 0, q_{i_0}(x, \xi) \geq 0,
- p(Q(x, \xi), \xi) - (q_{i_0} - x_{i_0})p'_Q(Q(x, \xi), \xi) + c_{i_0}'(q_{i_0}, \xi) \geq 0.
\]

Assume that \(q_{i_0}(x, \xi) = 0\). Then

\[
R'_{i_0}(0, x, Q_{-i_0}, \xi) = p(Q(x, \xi), \xi) - c'_{i_0}(0) - x_{i_0}p'(Q(x, \xi), \xi) \geq p(Q(x, \xi), \xi) - c'_{i_0}(0) > 0.
\]

The last inequality is due to (6.39). This contradicts the second inequality in the above complementarity conditions. This shows \(q_{i_0} > 0\) and hence \(q(x, \xi) \neq 0\). Moreover, the strict complementarity condition indicates that

\[
F_{i_0}(q(x, \xi), x, \xi) = G_{i_0}(q(x, \xi), x, \xi) = 0,
\]

and hence \(\theta_{i_0} = 1\). This demonstrates that \(\Theta\) is not a zero matrix under (3.7). We will use this result in the rest of the proof. By definition,

\[
R = \Theta \nabla_q G(q, x, \xi) + (I_M - \Theta) = \Theta(-p'_Q e - (q - x)p''_Q)e^T + \Theta(-p'_Q I_M + \nabla^2 c(q)) + (I_M - \Theta),
\]

and

\[
U = \Theta \nabla_x G(q, x, \xi) = \Theta p'_Q I_M.
\]

Let \(D = \Theta(-p'_Q I_M + \nabla^2 c(q)) + (I_M - \Theta)\). \(D\) is an \(M \times M\) diagonal matrix. It is easy to verify that \(D\) is non-singular and the inverse of \(D\) is

\[
D^{-1} = \text{diag} \left( \frac{1}{\theta_1(-p'_Q + c''_1(q_1))(1 - \theta_1)}, \ldots, \frac{1}{\theta_M(-p'_Q + c''_M(q_M))(1 - \theta_M)} \right).
\]

Let

\[
\gamma := e^T D^{-1} \Theta(-p'_Q e - (q - x)p''_Q) = \sum_{i=1}^{M} \frac{\theta_i(-p'_Q - p''_Q(q_i - x_i))}{\theta_i(-p'_Q + c''_i(q_i))(1 - \theta_i)}.
\]

By the well known Sherman-Morrison formula in linear algebra, we have

\[
R^{-1} = D^{-1} - \frac{1}{1 + \gamma} D^{-1} \Theta(-p'_Q e - (q - x)p''_Q)e^T D^{-1}.
\]
Let
\[ \gamma_i := \frac{\theta_i(-p'_Q - (q_i - x_i)p''_Q)}{\theta_i(-p'_Q + c_i^\prime(q_i)) + (1 - \theta_i)} \leq \frac{\theta_i(-p'_Q - Qp''_Q)}{\theta_i(-p'_Q + c_i^\prime(q_i)) + (1 - \theta_i)} \geq 0, \]
where the first inequality is due to the convexity of the inverse demand function and the second inequality is from Assumption 2.2. Because \( \gamma_i \geq 0 \), for \( i = 1, 2, \ldots, M \), we have \( \gamma = \sum_{i=1}^{M} \gamma_i \geq \gamma_i \) for any \( i = 1, 2, \ldots, M \). Consequently,

\[ -e^T R^{-1} U = -e^T \left[ D^{-1} - \frac{1}{1 + \gamma} D^{-1} \Theta(-p'_Q e - (q - x)p''_Q) e^T D^{-1} \right] \Theta p'_Q I_M \]

\[ = -e^T D^{-1} \Theta p'_Q I_M + \frac{1}{1 + \gamma} [e^T D^{-1} \Theta(-p'_Q e - (q - x)p''_Q) e^T D^{-1} p'_Q I_M \]

\[ = -e^T D^{-1} \Theta p'_Q I_M + \frac{\gamma}{1 + \gamma} e^T D^{-1} \Theta p'_Q I_M \]

\[ = - \frac{1}{1 + \gamma} e^T D^{-1} \Theta p'_Q I_M \]

\[ = - \frac{1}{1 + \gamma} \left( \frac{-\theta_1 p'_Q}{\theta_1(-p'_Q + c_1^\prime(q_1)) + (1 - \theta_1)} \cdots \frac{-\theta_M p'_Q}{\theta_M(-p'_Q + c_M^\prime(q_M)) + (1 - \theta_M)} \right)^T. \]

Let
\[ \kappa_i := \frac{-\theta_i p'_Q}{\theta_i(-p'_Q + c_i^\prime(q_i)) + (1 - \theta_i)} \geq 0, \quad i = 1, 2, \ldots, M. \]

By Assumption 2.2, \( -p'_Q > 0, c_i^\prime(q_i) \geq 0 \) and \( \theta_i \in [0, 1] \), hence we have \( \gamma > 0 \) and \( 0 \leq \kappa_i \leq 1 \), and

\[ -e^T R^{-1} U \subset \left[ 0, \frac{\kappa_1}{1 + \gamma} \right] \times \cdots \times \left[ 0, \frac{\kappa_M}{1 + \gamma} \right] \subset [0, 1) \times [0, 1) \times \cdots \times [0, 1). \]

Hence we have \( \partial_x Q(x, \xi) \subset \partial_x q(x, \xi)^T e \subset [0, 1) \times \cdots \times [0, 1) \) and \( \partial_y Q(x, \xi) \subset \partial_y q(x, \xi)^T e \subset [0, 1). \) Note that \( \theta_i = 0 \) corresponds to the case when \( F_i(q, x, \xi) = q_i(x, \xi) = 0 \). In this case, \( (q_i)'_x(x, \xi) = 0. \) Also, by Remark 2.5, \( (q_j)'_x(x, \xi) = 0. \) This shows \( \partial_x Q(x, \xi) = [0] \).

Part (iii). From the proof of Part (ii), \( q_i(x, \xi) > 0 \), therefore from the complementarity condition

\[ -p(Q, \xi) - (q_i - x_i)p'_Q(Q, \xi) + c'_i(q_i) = 0. \]
By using Clarke’s generalized implicit function theorem (Xu 2005, Lemma 2.2), we obtain
\[ \partial_{x_i} q_i(x, \xi) \subset \frac{-p'_Q + (p'_Q + (q_i - x_i)p''_Q)\partial_{x_i} Q(x, \xi)}{-p'_Q + c''_i(q_i)}. \] (6.40)

From the proof of Part (ii), the subdifferential \( \partial_{x_i} Q(x, \xi) \) is in the set \([0, \frac{\kappa_i}{1 + \gamma_i}]\). By the property of \( \gamma \), \( \gamma \geq \gamma_i > 0 \), we have
\[ \partial_{x_i} Q(x, \xi) \subset \left[ 0, \frac{\kappa_i}{1 + \gamma} \right] \subset \left[ 0, \frac{-\theta_i p'_Q}{\theta_i(-p'_Q - (q_i - x_i)p''_Q)} \right]. \]

Consequently, the subdifferential of \( q_i \) w.r.t. \( x_i \) is,
\[ \partial_{x_i} q_i(x, \xi) \subset \frac{-p'_Q + (p'_Q + (q_i - x_i)p''_Q)\partial_{x_i} Q(x, \xi)}{-p'_Q + c''_i(q_i)} \subset \left[ 0, \frac{\kappa_i}{1 + \gamma} \right] \subset \left[ 0, \frac{-\theta_i p'_Q}{\theta_i(-p'_Q - (q_i - x_i)p''_Q)} \right] \subset [0, 1]. \] (6.41)

Part (iv). As discussed in Part (iii), we have the following equation,
\[ -p(Q, \xi) - (q_i - x_i)p'_Q(Q, \xi) + c'(q_i) = 0. \]

By using Clarke’s generalized implicit function theorem (Xu 2005, Lemma 2.2), we obtain
\[ \partial_{x_j} q_i(x, \xi) \subset \frac{p'_Q + (q_i - x_i)p''_Q}{-p'_Q + c''_i(q_i)} \partial_{x_j} Q(x, \xi). \]

Similarly as the proof of Part (iii), we have
\[ \partial_{x_j} q_i(x, \xi) \subset \left[ \frac{p'_Q}{-p'_Q + c''_i(q_i)} \right] \subset (-1, 0], \]
which implies that every element of \( \partial_{x_j} q_i(x, \xi) \) is negative. This shows \( q_i(\cdot, \xi) \) is strictly decreasing w.r.t. \( x_j \) where \( q_i(\cdot, \xi) > 0 \).

Part (v). From the formulation of \( G(q, x, \xi) \), we have
\[ \nabla_{\xi} G(q, x, \xi) = -p'_q(q^T e, \xi) e - p''_{Q, \xi}(q^T e, \xi) q. \]

By the assumption that \( p''_{Q, \xi}(q^T e, \xi) = 0 \) in Proposition 3.7 (v), the above equation can be written as
\[ \nabla_{\xi} G(q, x, \xi) = -p'_q(q^T e, \xi) e. \]
The rest of the proof is similar to that of Part (ii). We include it for completeness. Let

\[ V := \Theta \nabla_\xi G(q, x, \xi) = -\Theta p'_\xi e, \]

and

\[ -e^T R^{-1} V = p'_\xi (e^T D^{-1}) \Theta e - \frac{\gamma}{1 + \gamma} p'_\xi (e^T D^{-1}) \Theta e = \frac{1}{1 + \gamma} p'_\xi (e^T D^{-1}) \Theta e. \]

By the assumption in statement (v) of this proposition, we have

\[ \gamma = \sum_{i=1}^{M} \frac{\theta_i (-p'_Q - (q_i - x_i) p''_Q)}{\theta_i (-p'_Q + c''_i(q_i)) + (1 - \theta_i)} > C \sum_{i=1}^{M} \frac{\theta_i}{\theta_i (-p'_Q + c''_i(q_i)) + (1 - \theta_i)} = Ce^T D^{-1} \Theta e. \]

Hence,

\[ -e^T R^{-1} V \leq \frac{p'_\xi e^T D^{-1} \Theta e}{1 + Ce^T D^{-1} \Theta e} \leq \frac{1}{C} p'_\xi. \]

\[ \square \]

**Proof of Theorem 4.3**  Part (i). Recall that in Theorem 3.5 (iii), we have shown that the solution \( q(x, x_{-i}, \xi) \) to equation \( F(q, x, \xi) = 0 \) is a Lipschitz continuous, piecewise smooth function of \( x_i \) for \( i = 1, 2, \ldots, M \). By Proposition 3.7 (iv), \( \partial_{x_i} q_i(x, x_{-i}, \xi) \subset [0, 1) \), which means that \( q_i(x, x_{-i}, \xi) \) is increasing in \( x_i \). Moreover, from (6.40), we have

\[ \partial_{x_i} q_i(x, x_{-i}, \xi) \subset \frac{-p'_Q + (p'_Q + (q_i - x_i) p''_Q) \partial_{x_i} Q(x, \xi)}{-p'_Q + c''_i(q_i)}. \]

Note that at a point where \( Q(x, \xi) \) is continuously differentiable, both \( \partial_{x_i} q_i(x, x_{-i}, \xi) \) and \( \partial_{x_i} Q(x, \xi) \) reduce to a singleton. Thus, \( q_i(x, x_{-i}, \xi) \) is a piecewise differentiable function of \( x_i \).

Part (ii). Let \( x_{i(1)}^1, x_{i(2)}^2 \geq 0 \) be any two positive numbers. From the proof above, we know that \( q_i(x, x_{-i}, \xi) \) is piecewise smooth in \( x_i \). At a point where the function is not differentiable, we have from (6.40)

\[ (q_i)_x(x, x_{-i}, \xi) = \frac{-p'_Q + (p'_Q + (q_i - x_i) p''_Q) Q'_x(x, \xi)}{-p'_Q + c''_i(q_i)}. \]

Since, \( q_i \in [0, \max\{q_i'', x_i\}] \) in Proposition 3.3, \( Q'_x(x, \xi) \in [0, 1) \) and \( (q_i)'_{x_i}(x, x_{-i}, \xi) \in [0, 1) \) for any feasible \( q_i \) and \( x_i \), \((q_i)'_{x_i}(x_i, x_{-i}, \xi) \) is bounded by a
that is, there exists a function \( L \) such that

\[
(q_i)'_{x_i}(x_i, x_{-i}, \xi) \leq \frac{-p'_Q + (\max\{q_i^u, x_i\} - x_i)p''_Q}{-p'_Q + c''(q_i)}.
\] (6.42)

By the mean value theorem,

\[
q_i(x_i^{(1)}, x_{-i}, \xi) - q_i(x_i^{(2)}, x_{-i}, \xi) = \int_0^1 (q_i)'_{x_i} \left(x_i^{(2)} + \theta(x_i^{(1)} - x_i^{(2)}), x_{-i}, \xi\right) (x_i^{(1)} - x_i^{(2)}) d\theta,
\]

and from (6.42), we have

\[
\left| (q_i)'_{x_i} \left(x_i^{(2)} + \theta(x_i^{(1)} - x_i^{(2)}), x_{-i}, \xi\right) \right| \leq (1 + \max\{q_i^u, x_i\})L_1(\xi)/\sigma.
\]

The conclusion follows by taking \( L_2^i(\xi) := (1 + \max\{q_i^u, x_i\})L_1(\xi)/\sigma. \)

Proof of Theorem 4.4 From Lemma 4.3, for any fixed \( x_{-i} \), we know that \( q_i(x_i, x_{-i}, \xi) \) is nondecreasing on \( x_i \) and thus \( x_i(\xi) \) is unique. Moreover, from the definition of \( x_i(\xi) \), we have that \( q_i(x_i(\xi), x_{-i}, \xi) = 0 \). By Part (v) of Proposition 3.7, \( q_i(x_i(\xi), x_{-i}, \xi) \) is increasing in both \( \xi \) and \( x_i \), thus \( x_i(\xi) \) must decrease at the points where \( \xi \) increase to maintain the equation \( q_i(x_i(\xi), x_{-i}, \xi) = 0 \).

The discussion above shows that for any \( x_i \geq 0 \) and any fixed \( x_{-i} \), there exists at most one \( \xi \in \Xi \), denoted by \( \xi_i \), for generator \( i \) such that \( q_i(x_i, x_{-i}, \xi) \equiv 0 \) for \( \xi \geq \xi_i \) and \( q_i(x_i, x_{-i}, \xi) > 0 \) for \( \xi \leq \xi_i \). Therefore \( \Xi(x) \) is a finite set.

Proof of Theorem 4.5 The proof can be divided into two steps, where first we show the once continuous differentiability of \( \pi_i(x_i, x_{-i}) \) w.r.t. \( x_i \) and, in the second step, we show that the function is twice continuously differentiable.

In the first step, we show the continuous differentiability, from Proposition 2 in Ruszczynski and Shapiro (2003) and the differentiability of \( v_i(\cdot, \xi) \) w.r.t. \( x_i \), we know that it is sufficient to prove that \( v_i(\cdot, \xi) \) is Lipschitz continuous with an integral module, that is, there exists a function \( L_4(\xi) \) such that

\[
\int_{\Xi} L_4(\xi) \rho(\xi) d\xi < \infty \quad \text{and} \quad |v_i(x_i^{(1)}, \xi) - v_i(x_i^{(2)}, \xi)| \leq L_4(\xi)|x_i^{(1)} - x_i^{(2)}|, \forall x_i^{(1)}, x_i^{(2)} \geq 0.
\] (6.43)

By assumption, at a point where \( Q(x, \xi) \) is differentiable w.r.t. \( x_i \), \( p(Q, \xi) \) is bounded by \( L_3(\xi) \). Furthermore, \( p'_Q \) is bounded by \( L_1(\xi) \) and \( 1 + Q'_{x_i}(x, \xi) \) takes its value in
There exists an integrable function $L_A$. Therefore
\[
\left| (v_i)_{x_i}^\prime (x_i, \xi) \right| = \left| (q_i)_{x_i}^\prime (x_i, x_{-i}, \xi) - 1 \right| p(Q(x, \xi), \xi) + q_i(x_i, x_{-i}, \xi) p_Q^\prime(Q(x, \xi), \xi) Q_{x_i} (x, \xi) - c_i^\prime(q_i(x_i, x_{-i}, \xi)) (q_i)_{x_i}^\prime (x_i, x_{-i}, \xi)
\]
\[
\leq \left| (q_i)_{x_i}^\prime (x_i, x_{-i}, \xi) - 1 \right| |L_3(\xi) + q_i(x_i, x_{-i}, \xi)L_1(\xi) + L_1(\xi) |
\]
\[
\leq L_3(\xi) + (q_i^\prime + 1)L_1(\xi).
\]

Define
\[
L_4(\xi) := L_3(\xi) + (q_i^\prime + 1)L_1(\xi),
\]
which satisfies the condition (6.43). Then we have, by the mean value theorem
\[
|v_i(x_i^{(1)}, \xi) - v_i(x_i^{(2)}, \xi)| \leq 1 \int_0^1 |(v_i)_{x_i}^\prime (x_i(\theta), \xi) + \theta(x_i^{(1)} - x_i^{(2)}, \xi))|x_i^{(1)} - x_i^{(2)}|d\theta
\]
\[
\leq L_4(\xi)|x_i^{(1)} - x_i^{(2)}|,
\]
which shows the once continuous differentiability of $\pi_i(x_i, x_{-i})$. Then, from Proposition 2 in Ruszczyński and Shapiro (2003), we can prove that
\[
\pi_i(x_i, x_{-i}) := \int_{\xi \in \Xi} \{ q_i(x_i, x_{-i}, \xi) p(Q(x, \xi), \xi) - c_i(q_i) \} \rho(\xi)d\xi
\]
is differentiable.

Next, we will show that the second derivative of $\pi_i(x_i, x_{-i})$ exists. To show this point, we again need to apply Proposition 2 in Ruszczyński and Shapiro (2003). It is sufficient to show that $(v_i)_{x_i}^\prime (\cdot, \xi)$ is differentiable w.r.t. $x_i$ for almost every $\xi \in \Xi$ and there exists an integrable function $L_5(\xi) \geq 0$ such that
\[
\int_{\Xi} L_5(\xi) \rho(\xi)d\xi < \infty, \quad \text{ and}
\]
\[
|(v_i)_{x_i}^\prime (x_i^{(1)}, \xi) - (v_i)_{x_i}^\prime (x_i^{(2)}, \xi)| \leq L_5(\xi)|x_i^{(1)} - x_i^{(2)}|, \quad \forall x_i^{(1)}, x_i^{(2)} \geq 0
\]
At any point where $Q_{x_i} (x, \xi)$ is differentiable w.r.t. $x_i$, we have
\[
(v_i)_{x_i}^{\prime\prime} (x_i, \xi) = (q_i)_{x_i}^{\prime\prime} (x_i, x_{-i}, \xi) p(Q(x, \xi), \xi)
\]
\[
+ 2q_i(x_i, x_{-i}, \xi) p_Q^\prime(Q(x, \xi), \xi) Q_{x_i} (x, \xi)
\]
\[
+ q_i(x_i, x_{-i}, \xi) p_Q^\prime(Q(x, \xi), \xi)^2
\]
\[
+ q_i(x_i, x_{-i}, \xi) p_Q^\prime(Q(x, \xi), \xi) Q_{x_i} (x, \xi)
\]
\[ \pi_1 \text{ is dominated by an integrable bound } L. \]

Together with Assumptions 2.1, 2.6 and 3.6, this guarantees the existence and uniqueness of equilibrium in the spot market by Proposition 3.3. We proceed the proof in two steps: Step 1, we consider points where \( q_j(x_i, x_{-i}, \xi) \) turns from strictly positive to zero at the point, for some \( j \neq i \). From the discussion above, we have that, for fixed \( x_{-i} \), \( q_j(x_i, x_{-i}, \xi) \) is piecewise smooth w.r.t. \( x_i \) and \( \xi \). For any fixed \( x_{-i} \), we denote the point at which \( q_j(x_i, x_{-i}, \xi) \) turns from zero to \( \xi > 0 \) for fixed \( x_{-i} \), as stated in Section 3, we first show that \( q_j(x_i, x_{-i}, \xi) \) is a piecewise smooth function of \( x_i \) and \( \xi \). For any fixed \( x_{-i} \) and \( \xi \), \( q_j(x_i, x_{-i}, \xi) \) is non-decreasing. Note that Assumptions 2.2 and 4.2 are satisfied by the assumptions of this theorem, it is easy to derive that, for any fixed \( x_{-i} \),

\[
\left| (v_i)_{x_i}''(x_i, \xi) \right| \leq L_5(\xi) := L_3(\xi) L_3(\xi) + 2 q_i'' L_1(\xi) + q_i'' L_1(\xi) + q_i'' L_3(\xi) L_3(\xi) + L_3(\xi) L_1(\xi) = 3 q_i'' L_1(\xi) + (q_i'' L_1(\xi) + L_3(\xi) L_3(\xi) + L_1(\xi)) L_3(\xi).
\]

Because of \( L_1(\xi) \) is bounded and \( L_3(\xi) \) is integrable, then \( L_5(\xi) \) is also integrable. This shows that \( \pi_i(x_i, x_{-i}) \) is twice differentiable.

Finally, to complete our proof, we investigate the continuity of the second derivative of \( \pi_i(x_i, x_{-i}) \). For any fixed \( x_{-i} \), to show the continuity of \( \pi_i'(x_i, x_{-i}) \) and \( \pi_i''(x_i, x_{-i}) \), we note that \( (v_i)_{x_i}''(\cdot, \xi) \) is a continuous function of \( x \) for almost every \( \xi \in \Xi \) and \( (v_i)_{x_i}'' \) is dominated by an integrable bound \( L_5(\xi) \). By the Lebesgue dominated convergence theorem, for any fixed \( x_{-i} \)

\[
\lim_{z \to x_i} \pi_i''(z, x_{-i}) = \int \lim_{z \to x_i} (v_i)_{x_i}''(z, x_{-i}, \xi) \rho(\xi) d\xi = \int (v_i)_{x_i}''(x_i, x_{-i}, \xi) \rho(\xi) d\xi = \pi_i''(x_i, x_{-i}).
\]

This completes the proof. \( \Box \)

Proof of Proposition 4.9 We use a methodology analogous to that in DeMiguel and Xu (2008, Proposition 4.2) to prove the results. That is, we show the derivative of \( Q \) w.r.t. \( x_i \) is non-decreasing. Note that Assumptions 2.2 and 4.2 are satisfied by the inverse demand function and the type of cost functions considered in this proposition. Together with Assumptions 2.1, 2.6 and 3.6, this guarantees the existence and uniqueness of equilibrium in the spot market by Proposition 3.3. We proceed the proof in two steps: Step 1, we consider points where \( Q \) is not differentiable w.r.t. \( x_i \); Step 2, we consider points where \( Q \) is continuously differentiable w.r.t. \( x_i \). Note that by Theorem 3.5, \( q(x, \xi) \) is piecewise smooth w.r.t. \( x_i \). For fixed \( x_{-i} \), as stated in Section 3, we first show that \( Q(x_i, x_{-i}, \xi) \) is a piecewise smooth and convex function of \( x_i \) at a point where \( q_i(x_i, x_{-i}, \xi) \) turns from zero to strictly positive and the points where \( q_j(x_i, x_{-i}, \xi) \), for \( j \neq i \), turns from strictly positive to zero. At all other points, the function is smooth.

Let \( I(x_i, \xi) \) denote the index set of the generators with \( q_j(x_i, x_{-i}, \xi) > 0 \) for fixed \( x_{-i} \) and \( j \neq i \). Then \( I(x_i(\xi)_-, \xi) \setminus I(x_i(\xi)_+, \xi) \) is the index set of generator \( i \)'s rivals.
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which turn from a positive supply to zero at \( x_i(\xi) \), where

\[
I(x_i(\xi) -, \xi) = \lim_{\delta \to 0} I(x_i(\xi) - \delta, \xi), \quad I(x_i(\xi) +, \xi) = \lim_{\delta \to 0} I(x_i(\xi) + \delta, \xi),
\]

for any \( j \neq i \).

Because \( q_i(x_i, x_{-i}, \xi) \) is piecewise smooth in \( x_i \) (nonsmooth only at a finite number of points), we may assume that in a neighborhood of \( x_i(\xi) \), the function \( q_i(x_i, x_{-i}, \xi) \) is differentiable except at \( x_i(\xi) \). Since \( p(Q, \xi) \) is linear in \( Q \), it follows from the complementary equation (3.9) that \( G(q(x, \xi), x, \xi) = 0 \) for \( x \) in a left neighborhood of \( x_i(\xi) \) where \( q_i(x_i, x_{-i}, \xi) > 0 \), we have, for generator \( i \),

\[
(q_i)'_{x_i}(x_i, x_{-i}, \xi) = \frac{1}{-p'_Q + c''_i(q_i)} \left[ -p'_Q + (p'_Q + (q_i - x_i)p''_Q) Q'_x(x, \xi) \right], \quad (6.44)
\]

and

\[
(q_j)'_{x_i}(x_i, x_{-i}, \xi) = \frac{1}{-p'_Q + c''_j(q_j)} \left[ p'_Q + (q_j - x_j)p''_Q \right] Q'_x(x, \xi). \quad (6.45)
\]

We consider two cases: Case (i) \( q_i(x_i, x_{-i}, \xi) > 0 \), and Case (ii) \( q_i(x_i, x_{-i}, \xi) = 0 \).

Case (i). Adding the Eq. (6.45) for all \( j \in I(x_i, \xi) \) and subtracting (6.44), we have that

\[
Q'_{x_i}(x, \xi) - (q_i)'_{x_i}(x_i, x_{-i}, \xi) = \sum_{j \in I(x_i, \xi)} (q_j)'_{x_i}(x_i, x_{-i}, \xi)
\]

Under the assumptions of this proposition, we have either \( c''_j = 0 \) or \( c''_j \) are identical (in which we denote the derivative by \( c'' \) for the cost functions defined in Condition 1 and 2 in Proposition 4.9 ). Consequently, we have

\[
Q'_{x_i}(x, \xi) - (q_i)'_{x_i}(x_i, x_{-i}, \xi) = \frac{1}{-p'_Q + c''} \sum_{j \in I(x_i, \xi)} \left[ p'_Q + (q_j - x_j)p''_Q \right] Q'_x(x, \xi).
\]

Since \( p(Q, \xi) = \alpha(\xi) - \beta(\xi)Q \), (6.46) is equivalent to

\[
Q'_{x_i}(x, \xi) - \frac{1}{\beta(\xi) + c''} \left[ \beta(\xi) - \beta(\xi) Q'_{x_i}(x, \xi) \right] = \frac{1}{\beta(\xi) + c''} \sum_{j \in I(x_i, \xi)} \left[ -\beta(\xi) Q'_{x_i}(x, \xi) \right].
\]
Let $|\mathcal{I}|$ denote the cardinality of $\mathcal{I}(x_i, \xi)$. Then we can reformulate (6.46) as

$$Q_{x_i}'(x, \xi) = \frac{1}{2 + |\mathcal{I}| + c''/\beta(\xi)}.$$  

(6.47)

Since $(q_j)_{x_i}(x_i, x_{-i}, \xi) \in (-1, 0], |\mathcal{I}(x_i, \xi)|$ is a decreasing function of $x_i$, $2 + |\mathcal{I}| + c''/\beta(\xi)$ is an increasing function of $x_i$. This implies the convexity of $Q$ in $x_i$ at the point $x_i(\xi)$.

Case (ii). Since $q_i(x, \xi) = 0$, by the proof in Proposition 3.7, $Q_{x_i}' = 0$ at the left side of the neighborhood of $x_i(\xi)$. At the right side of the neighborhood of $x_i(\xi)$, $Q_{x_i}' > 0$. This shows the convexity of $Q$ in $x_i$ at the point $x_i(\xi)$.

**Step 2.** Let us consider the points $x_i$ at which both $q_i(x_i, x_{-i}, \xi)$ and $q_j(x_i, x_{-i}, \xi)$ are continuously differentiable w.r.t. $x_i$. In this case,

$$\mathcal{I}(x_i - \delta, \xi) = \mathcal{I}(x_i + \delta, \xi) = \mathcal{I}(x_i, \xi),$$

for $\delta > 0$ sufficiently small. We can establish (6.47) and the rest of arguments are similar to Step 1 except that $|\mathcal{I}|$ is a constant.

**References**


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