On the co-existence of spot and contract markets: the delivery requirement as contract externality

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Summary:A contract between an upstream and a downstream party consists of a contract price and a delivery requirement. Contract formation entails an externality. It changes the probability distribution of the spot market price by removing high reservation price buyers and various sellers from the spot market. The first effect decreases the expected spot market price when the number of contracts is small, whereas the decrease in the number of sellers and additional residual contract demand increase the expected spot market price beyond a certain number of contracts. It implies an endogenous upper bound on the number of contracts. Contract prices are positively related to the number of contracts. Finally, additional contract formation reduces the variance of the spot market price when the number of contracts is sufficiently large.

Keywords: spot market, contract externality, co-existence, delivery requirement

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