Auctions with Unknown Capacities:
Understanding Competition among Renewables[*]

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Abstract

The energy transition will imply a change in the competitive paradigm of electricity markets. Competition-wise, one distinguishing feature of renewables versus fossil fuels is that their marginal costs are known but their available capacities are uncertain. Accordingly, in order to understand competition among renewables, we analyze a uniform-price auction in which bidders are privately informed about their random capacities. Renewable plants partially mitigate market power as compared to conventional technologies, but producers are still able to charge positive markups. In particular, firms exercise market power by either withholding output when realized capacities are large or by raising their bids above marginal costs when they are small. Since markups are decreasing in realized capacities, a positive capacity shock implies that firms offer to supply more at reduced prices, giving rise to lower but also more volatile market prices. An increase in capacity investment depresses market prices, which converge towards marginal cost when total installed capacity is sufficiently large, or when the market structure is sufficiently fragmented.

Keywords: multi-unit auctions, electricity markets, renewables, forecasts.

1 Introduction

Ambitious environmental targets, together with decreasing investment costs, have fostered the rapid deployment of renewable energy around the world. Installed renewable capacity has more than doubled over the last ten years and it is expected to further increase during the coming decade.[1] How will electricity markets perform in the future once renewables become the major energy source?

Whereas competition among conventional fossil-fuel generators is by now well understood (e.g. Borenstein, 2002; von der Fehr and Harbord, 1993; Green and Newbery, 1992, among others) much less is known about competition among wind and solar producers (which we broadly refer to as *renewables*). Competition-wise, there are two key differences between conventional and renewable technologies. First, the marginal cost of conventional power plants depends on their efficiency rate as well as on the price at which they buy the fossil fuel. In contrast, the marginal cost of renewable generation is essentially zero, as plants produce electricity out of freely available natural resources (e.g. wind or sun). Second, the capacity of conventional power plants is well known, as they tend to be available at all times (absent rare outages). In contrast, the availability of renewable plants is uncertain, as it depends on weather conditions that are forecast with error (Gowrisankaran et al., 2016).[2] Hence, the move from fossil-fuel generation towards renewable sources will imply a change in the competitive paradigm. Whereas the previous literature has analyzed environments in which marginal costs are private information but production capacities are publicly known (Holmberg and Wolak, 2018), the relevant setting will soon be one in which marginal costs are known (and essentially zero) but firms' available capacities are private information.

In this paper, we build a model that captures this new competitive paradigm, and we apply to electricity markets. We show that private information on capacities changes the

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[1]In several jurisdictions, the goal to achieve a carbon-free power sector by 2050 will require an almost complete switch towards renewable energy sources. The International Renewable Energy Agency estimates that compliance with the 2017 Paris Climate Agreement will require overall investments in renewables to increase by 76% in 2030, relative to 2014 levels. Europe expects that over two thirds of its electricity generation will come from renewable resources by 2030, with the goal of achieving a carbon-free power sector by 2050 (European Commission, 2012). Likewise, California has recently mandated that 100% of its electricity will come from clean energy sources by 2045.

[2]Our analysis applies mainly to wind and solar power, which are the most relevant renewable technologies. However, strictly speaking, not all renewable power sources share their characteristics. Other renewable technologies, such as hydro electricity, are storable or have a production that can be managed, very much like thermal plants (e.g. biomass plants).

nature of equilibrium bidding behavior, no matter how big or small the source of private information is. We assume that firms' available capacities are subject to common and idiosyncratic shocks: the former are publicly observable, the latter are privately known. Firms compete by submitting a price-quantity pair (i.e., a rotated-L supply function), indicating the minimum price at which they are willing to produce, and the maximum quantity they are willing to provide. A distinguishing feature of our model as compared to other auction models is that we allow firms to choose both the price and quantity dimensions. The auctioneer calls firms to produce in increasing price order until total demand is satisfied, and all accepted offers are paid at the market-clearing price (i.e., a uniform-price auction).

In equilibrium, we show that firms exercise market power by offering all their capacity at a price above marginal cost, i.e., *à la* Bertrand, or by withholding capacity, i.e., *à la* Cournot. An interesting insight from our model is that the mode of competition is determined endogenously, with small capacity realizations giving rise to Bertrand-like competition and large capacity realizations giving rise to Cournot-like competition.

In particular, when a firm's realized capacity is below total demand, the firm adds a mark-up over its marginal costs that is decreasing in its realized capacity. This reflects the standard trade-off faced by competing firms: decreasing the price leads to an output gain (quantity effect), but it also leads to a lower market price if the rival bids below (price effect). Since firms gain more from the quantity effect when their realized capacity is large, they are more eager to offer lower mark-ups. Instead, when a firm's realized capacity is above total demand, the firm exercises market power by withholding output in order to let the rival firm set a high market price. We also show that not allowing firms to withhold their output does not necessarily engender more competitive outcomes, given that firms offer higher mark-ups if not allowed to withhold.

The above mechanism implies that market prices are lower (higher) at times of high (low) capacity availability. Thus, price volatility is inherently linked to market power, not to capacity uncertainty per se (in the absence of market power, prices would be flat at marginal costs regardless of capacity realizations). In the long-run, an increase in capacity investment depresses expected market prices, which converge towards marginal costs when total installed capacity is sufficiently large (or when the market structure is

sufficiently fragmented).[3]

As in standard oligopoly models, entry reduces mark-ups both because of the increase in the number of firms and because of the expansion in existing capacity. Instead, changes in the ownership structure (e.g. through mergers or divestitures) have countervailing effects. On the one hand, mergers make firms bigger, thus inducing them to bid less aggressively. On the other, mergers also give rise to multi-plant firms, thus inducing them to submit lower bids. The reason is that multi-plant firms bid according to the average of their plants' realized capacities, thus flattening the distribution of their total capacity. The analysis of competition across ex-ante symmetric firms also shows that concentration results in higher expected prices. The firm which is small ex-ante tends to submit higher bids, knowing that it is likely to be underbid by its larger competitor. This asymmetry in bidding incentives is exacerbated the stronger the ex-ante capacity asymmetries across firms.

A natural question is whether information precision affects bidding behavior and thus market outcomes.[4] We find that uncertainty over firms' available capacities weakens their market power. In our model, capacity asymmetries induce firms to compete less fiercely because their optimal bids tend to be away from each other. However, firms need to be informed about their realized capacities in order to be aware of their asymmetries. Otherwise, if their expected capacities are equal, they bid symmetrically, resulting in head-to-head competition. As a consequence, the highest profit levels are obtained when capacities are publicly known, while the lowest ones are obtained under unknown capacities. In between, when firms are privately informed about their own capacities, equilibrium profits are higher the more precise is the information about the rivals' capacities. This suggests that firms might be better off exchanging information on their available capacities in order to sustain higher equilibrium profits, at the consumers' expense. For the same reason, regulators should refrain from providing detailed information about firms' available capacities prior to bidding. Our results thus provide a theoretical explanation to the experimental findings in Hefti et al. (2019), which are reminiscent of the literature on Treasury auctions (LiCalzi and Pavan, 2005) showing that noise in the

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[3]Bushnell and Novan (2018) reach a similar conclusion in a counterfactual exercise that uses data from the Californian electricity market.

[4]Lagerlöf (2016) also addresses this question, but he does so in the context of the Hansen-Spulber model of price competition under cost uncertainty (Hansen, 1988; Spulber, 1995). Our conclusion is similar to Lagerlöf (2016)'s, even if the drivers differ.

demand function rules out the seemingly collusive equilibria that arise otherwise (Back and Zender, 2001).

Finally, even though we have motivated our model in the context of electricity markets, our results may also provide valuable insights in other contexts where auctions are used and bidders may be privately informed about the maximum number of units they are willing to buy or sell. To name just a few examples, in Treasury Bill auctions (Hortaçsu and McAdams, 2010; Kastl, 2011), banks are privately informed about their hedging needs and, consequently, on the volume of bonds they are willing to buy; in Central Banks' liquidity auctions (Klemperer, 2019), banks are privately informed about the volume of toxic assets they can provide as collateral; or in emission permits auctions, firms are privately informed about their carbon emissions and hence about the amount of permits they need to purchase.[5] Likewise, firms have private information on capacities in a wide range of markets that can be analyzed through the lens of auction theory (Klemperer, 2003), e.g. the markets for hotel bookings or ride-hailing services, in which firms are privately informed about the number of empty rooms or available cars. Our model provides a framework that can account for this source of private information, thus complementing previous papers that focus on private information on costs or valuations.[6] As we argue below, these two sources of private information have distinct effects on bidding behavior and market outcomes. In particular, market prices tend to be more responsive to capacity than to cost shocks as the former affect both the price and the quantity offers made by firms.

Related literature. Other recent papers have also analyzed competition among renewables by introducing capacity uncertainty (Acemoglu et al., 2017 and Kakhbod et al., 2018). These papers, unlike ours, assume Cournot competition, i.e., they constrain firms to exercise market power by withholding output.[7] Acemoglu et al. (2017) focus on the

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[5]Other examples include spectrum auctions (Milgrom, 2004), procurement auctions for a wide range of goods and services, auctions for electricity generation capacity (Fabra, 2018; Llobet and Padilla, 2018), or auctions for investments in renewables (Cantillon, 2014), among others.

[6]While incomplete information on capacities can be captured through incomplete information on costs or valuations, this approach typically requires marginal costs (or valuations) to be bounded and continuous. Some papers allow for discrete valuations with a maximum number of units demanded, but assume that such limit is common knowledge (Hortaçsu and McAdams, 2010), or focus on the empirical identification of the optimal bids from the First Order Condition of profit maximization.

[7]In a context without uncertain renewables, Genc and Reynolds (2019) and Bahn et al. (2019) also assume Cournot competition to analyze the effects of the ownership structure of renewables on market outcomes. The trade-offs that arise when relying on a simple and tractable setup, like the Cournot model, versus one that more closely mimics the institutional details of electricity markets, like an auction model,

effects of joint ownership of conventional and renewable plants. They show that joint ownership weakens the price-depressing effect of renewables as strategic firms withhold more output from their conventional power plants when there is more renewable generation. This effect would clearly not be present in 100% renewables markets, which are the subject of our paper. Kakhbod et al. (2018) focus on the heterogeneous availability of renewable sources across locations and show that firms withhold more output when their plants are closely located, i.e., when their output is highly and positively correlated.

Holmberg and Wolak (2018) and Vives (2011) analyze auctions in which firms are privately informed about their marginal costs. In Holmberg and Wolak (2018) firms know their capacities and compete by choosing price offers. In Vives (2011) firms face uncertain quadratic costs and unbounded production capacities, and compete by choosing continuously differentiable supply functions. In Holmberg and Wolak (2018), a lower (higher) cost realization shifts firms' price offers down (up) while firms' quantity offers remain unchanged. This is unlike our model in which a higher (lower) capacity realization shifts the supply function downwards and outwards (upwards and inwards) as both prices and quantities respond to private information. In Vives (2011) firms receive an imprecise signal about their costs, which are correlated across firms. Since the market price aggregates information, firms submit steeper supply functions so as to produce less (more) when market prices are high (low), which occurs when marginal costs are likely to be high (low) as well. Hence, due to cost correlation, private information in Vives (2011) gives rise to less competitive equilibria than under full information. Instead, in the private values model, the equilibrium converges to its full information counterpart.

Interestingly, the comparison of our paper with Holmberg and Wolak (2018) and Vives (2011) uncovers a fundamental difference between introducing private information on costs or on capacities.[8] Private information has two potential effects on bidding behavior: through the bidders' price offers and through the quantities they sell. In a private-values setting with private information on costs, a firm's realized cost determines its bid (higher

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have been extensively discussed in the previous literature. See among others, Wolfram (1998) and von der Fehr and Harbord (1993).

[8]There are other differences between our paper and Holmberg and Wolak (2018) and Vives (2011). Notably, the bidding format is different. In the former, firms only choose price offers, where in ours they can also choose quantity offers. In the latter, firms compete by choosing continuously differentiable supply functions unlike in our setting and Holmberg and Wolak (2018) where firms choose step-wise supply functions. However, the fundamental differences highlighted here on the nature of private information apply regardless of the differences in the bidding format.

cost firms offer higher prices), but it does not affect (for a given bid) the quantity served by the rival. Instead, when capacities are private information, a firm's realized capacity not only determines its bid (more production is offered at lower prices) but it also affects the quantity served by the rival. Contingent on being the high bidder the rival serves the residual demand. This effect makes the equilibrium price offers steeper, as a firm with a small realized capacity has stronger incentives to raise its bid than if quantities were not affected by the rivals' private information.[9] This difference also explains why, in contrast to Holmberg and Wolak (2018) and Vives (2011), the equilibrium in our model always departs from the one under full information. The properties of our equilibrium are closer to the ones with positively affiliated signals on costs, even if we assume that capacity shocks are independent across firms.[10]

The comparison of our model with the ones in Holmberg and Wolak (2018) and Vives (2011) also shows that, with private values, equilibrium market prices tend to be more responsive to capacity shocks than to cost shocks. The channel is two-fold. First, as already argued, equilibrium bids are steeper when capacities (rather than costs) are private information. Thus, changes in the available capacity imply large changes in the price offers and, consequently, on the market prices. Second, since equilibrium price offers are decreasing in realized capacities, firms offer lower prices precisely when they can produce more. Again, this pushes market prices further down in response to positive capacity shocks.

The remainder of the paper is structured as follows. Section 2 describes the model and interprets it in the context of electricity markets. Section 3 characterizes equilibrium bidding behavior when firms' capacities are private information. Section 4 studies the impact of private information and information precision on equilibrium outcomes. Section 5 provides some extensions and variations of our main model, including aspects related to the market structure (an increase in ex-ante asymmetries, entry and mergers) and market design (a ban on capacity withholding). Last, Section 6 concludes by discussing what we can learn about competition among renewables. All proofs are relegated to the appendix.

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[9]Note that, conditionally on being smaller than the rival, the expected residual demand faced by a firm is larger the smaller its own capacity.

[10]With positively affiliated signals, a higher cost signal increases (for a given price) the probability of selling a higher quantity as the rival's cost, and thus its price offer, is also expected to be higher. Therefore, a firm's quantity is affected by the rival's private information, just as in our model.

2   The Model

Two ex-ante symmetric firms $i = 1, 2$ compete in a market to serve a perfectly price-inelastic demand, denoted as $\theta > 0$. Firms can produce at a constant marginal cost $c \geq 0$ up to their available capacities,[11] which are assumed to be random. In particular, the available capacity of firm i, denoted as $k_i > 0$, is the result of two additive components, $k_i \equiv \beta\kappa + \varepsilon_i$. The parameter $\beta \in [0, 1]$ in the common component captures the proportion of each firm's nameplate capacity κ that is available. The idiosyncratic shock ε_i is distributed according to $\Phi(\varepsilon_i|\kappa)$ in an interval $[\underline{\varepsilon}, \overline{\varepsilon}]$, with $E(\varepsilon_i) = 0$. As a result, firm i's available capacity k_i is distributed according to $G(k_i) = \Phi(k_i - \beta\kappa|\kappa)$ in the interval $k_i \in [\underline{k}, \overline{k}]$, where $\underline{k} = \beta\kappa + \underline{\varepsilon}$ and $\overline{k} = \beta\kappa + \overline{\varepsilon}$. We denote the density as $g(k_i)$ and we assume it is positive in the whole interval $[\underline{k}, \overline{k}]$. We also assume $2\underline{k} \geq \theta$ to make sure there is always enough available capacity to cover total demand. Note that firms' available capacities are positively correlated through the common component, but they are conditionally independent given β. Firm i can observe its own idiosyncratic shock but not that of its rival, i.e., available capacities are private information.

Firms compete on the basis of the bids submitted to an auctioneer. Each firm simultaneously and independently submits a price quantity pair (b_i, q_i), where b_i is the minimum price at which it is willing to supply the corresponding quantity q_i. We assume $b_i \in [0, P]$, where P denotes the "market reserve price." We also assume that firms cannot offer to produce above their available capacity or below their minimum capacity, $q_i \in [\underline{k}, k_i]$, for $i = 1, 2$.[12]

The auctioneer ranks firms according to their price offers, and calls them to produce in increasing rank order. In particular, if firms submit different prices, the low-bidding firm is ranked first. If firms submit equal prices, firm i is ranked first with probability $\alpha(q_i, q_j)$ and it is ranked second with probability $1 - \alpha(q_i, q_j)$. We assume a symmetric function $\alpha(q_i, q_j) = \alpha(q_j, q_i) \in (0, 1)$.[13] If firm i is ranked first it produces $\min\{\theta, q_i\}$, while if it is ranked second it produces $\max\{0, \min\{\theta - q_j, q_i\}\}$.

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[11] We can set $c = 0$ without loss of generality. In the context of renewables, a positive c could reflect the operation and maintenance variable costs. It could also be interpreted as the opportunity cost of firms whenever they have the option of selling this output through other channels, e.g. bilateral contracts or balancing markets.

[12] The implicit assumption is that withholding below $\underline{k}$ would make it clear that the firm has strategically reduced output in order to raise prices, thus triggering regulatory intervention.

[13] Hence, when firms' quantity offers are equal, $\alpha(q, q) = 1/2$. We do not need to specify $\alpha(q_i, q_j)$ outside of the diagonal as this is inconsequential for equilibrium bidding.

Firms receive a uniform price per unit of output, which is set equal to the market clearing price. For $b_i \geq b_j$, the market clearing price is defined as

$$p = \begin{cases} b_i & \text{if } q_i > \theta, \\ b_j & \text{if } q_i \leq \theta \text{ and } q_i + q_j > \theta, \\ P & \text{otherwise.} \end{cases}$$

In words, the market clearing price is set by the highest accepted bid, unless the quantity offered by the winning bid(s) is exactly equal to total demand. In this case, the market price is set equal to the lowest non-accepted bid, or to P if no such bid exists (because all the quantity offered has been accepted).[14]

The profits made by each firm are computed as the product of their per unit profit margin $(p - c)$ and their dispatched output. As explained before, both the market price p as well as firms' outputs are a function of demand θ and the prices (b_i, b_j) and quantities (q_i, q_j) offered by both firms. Firms, which are assumed to be risk neutral, bid so as to maximize their individual expected profits, given their realized capacities.

2.1 Interpreting the Model

The model described above is applicable to a wide range of auction settings in which firms' capacities (or demands) have a private-information component. As already discussed, in electricity auctions, the supply of renewable generators depends on their available capacities, which are subject to idiosyncratic shocks. In emission auctions, the demand for permits by polluting firms depends on their emissions and abatement costs. In Treasury Bill auctions, the demand by banks depends on their hedging needs, which in turn depend on how many loans and deposits they have taken. Similarly, in Central Bank's auctions, the demand for liquidity depends on the amount and quality of the banks' collateral.[15]

Our model has being built to understand the future performance of electricity markets, and so it captures some of their key characteristics. Notably, similarly to most electricity

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[14]Assuming that the market price is set at the lowest non-accepted bid when the quantity offered by the winning bid(s) equals total demand is made for analytical convenience, with no impact on equilibrium outcomes. In particular, it avoids situations where firms want to offer a quantity slightly below total demand in order to push the market price up to the higher bid offered by the rival.

[15]Similar examples can be found in markets which are not organized as formal auctions: how much oil an oil producer is willing to sell depends on the remaining oil in the well; how many available cars a ride-hailing company has depends on how many drivers are on service, net of those who are already occupied; how many rooms a hotel is willing to offer online depends on how many rooms have been booked through other channels; how much cloud computing space a firm is willing to offer depends on how much excess capacity it has above its own data needs; or how much olive oil a firm is willing to sell depends on whether its harvest was good or bad.

markets in practice, the model assumes that firms compete by submitting a finite number of price-quantity pairs to an auctioneer, who then allocates output and sets market prices according to such bids.[16] We have assumed that demand is price-inelastic and known by the time firms submit their bids. This is justified on two grounds. First, electricity retail prices typically do not reflect movements in spot market prices, and even where they do, consumers typically do not have strong incentives or the necessary information to optimally respond to hourly price changes.[17] Second, system operators regularly publish very precise demand forecasts before the market opens. Extending the model to allow for some degree of demand elasticity and/or demand uncertainty would add a layer of complexity without a significant impact on its main predictions.

Regarding supply, we have not allowed for a meaningful coexistence between renewables and conventional technologies because our aim is to shed light on the performance of electricity markets during the late stages of the energy transition, when conventional technologies will mainly serve as back-up. Still, one could interpret that conventional technologies are implicitly present in the model through P, as it plays the same role as the marginal costs of coal or gas plants (as long as these conventional plants are not owned by the renewable producers). Alternatively, and consistent with most real electricity markets, P can be interpreted as a explicit price cap or an implicit one that triggers regulatory intervention. We have assumed that P is known, but the model could be extended to allow it to be stochastic.

Importantly, one of the core assumptions of our analysis is that firms possess private information that allows them to perfectly forecast their available capacities. In practice, as captured by our model, the availability of renewable resources is subject to common and idiosyncratic shocks. Firms' available capacities are thus correlated through the common shock component, albeit imperfectly so due to the presence of idiosyncratic shocks. While system operators typically publish forecasts of the common shock at the national or regional level, the idiosyncratic component remains each firm's private information. Indeed, through the monitoring stations installed at the renewable plants' sites, firms

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[16]While in practice firms are allowed to submit more than one step in their bidding functions, because of tractability reasons we restrict them to submitting just one. The same constraint applies to other papers in the electricity auctions literature (Holmberg and Wolak, 2018; Fabra et al., 2006). Analyzing the model with multiple steps is beyond the scope of this paper.

[17]The empirical evidence shows that this is the case in the Spanish electricity market, the only country so far where Real Time Pricing has been implemented as the default option for all households (Fabra et al., 2019). This might change once automation devices become more broadly deployed.

have access to local weather measurements that are not available to the competitors. Beyond weather conditions, the plants' availability might be subject to random outages and maintenance schedules that only their owners are aware of. Accordingly, in the presence of private information, each firm is better informed about its own available capacity than its competitors. Our model applies even in those settings in which the amount of private information is relatively small.

To illustrate this claim empirically, we have collected data from the Spanish electricity market to perform and compare forecasts of each plant's production, with and without firms' private information. In particular, we have obtained proprietary data of six renewable plants corresponding to their hourly production and their own available forecasts at the time of bidding, for a two-year period. We have also gathered the forecasts computed by the Spanish System Operator (Red Eléctrica de España) and the one-day ahead predictions of the Spanish weather agency (Agencia Estatal de Meteorología or AEMET) at provincial level, which is the most disaggregated local level available, close to the plant's location. We have used OLS to forecast each plants' hourly availability, with and without the firms' proprietary local data. Figure 1 plots the distribution of the forecast errors and Table 1 summarizes the mean and standard deviations of the corresponding forecast errors. The evidence suggests that firms possess private information that allows them to significantly improve the precision of the forecasts of their own plants' available capacities.[18] Interestingly, when the private forecast is used, the national forecast, while still statistically significant, has a small economic impact in the prediction.

As shown by these results, firms' forecast errors are centered around zero, but the standard deviations remain significant even when firms have private information about their own capacities. Nevertheless, the day-ahead market price and output allocation are computed using firms' committed quantities, even when these differ from their actual ones. Hence, for bidding purposes, what matters is that each firm knows exactly how much output it has offered in the day-ahead market, and not necessarily how much it will be able to produce in real time. This is consistent with our model, since we have assumed that firms know exactly their available capacity before submitting their bids.

The day-ahead market, which concentrates the vast majority of trade, is typically followed by a series of balancing markets that operate closer to real time. In general,

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[18]We have also used more general specifications, such as a LASSO, with almost identical results.

Variables	(1)	(2)
Public forecast	0.582***	0.070***
	(0.035)	(0.021)
Private forecast		0.657***
		(0.008)
Observations	36,671	36,671
R-squared	0.520	0.826
Standard deviation of the error	.18	.11

Table 1: Forecast errors with public versus private information.

Note: The dependent variable is the plant's hourly production normalized by its nameplate capacity. Both regressions include weather data (temperature, wind speed and atmospheric pressure) as well as plant, hour and date fixed effects. The robust standard errors are in parentheses *** p<0.01, ** p<0.05, * p<0.1. One can see that using the plant's own forecast significantly reduces the forecast error, with the R^2 increasing from 0.520 to 0.826. When the private forecast is used, the public forecast is still statistically significant but it has a small impact on the prediction.

participation in these markets leads to less favorable prices, and this means that (absent strategic considerations) firms try to avoid imbalances (Hortaçsu and Puller, 2008) by offering in the day-ahead market their best capacity estimate. Adding the potential dynamic effects introduced by these sequential markets is beyond the scope of this analysis (See Ito and Reguant (2016)).

3 Equilibrium Characterization

In this section we characterize the Bayesian Nash Equilibria (BNE) of the game when capacities are private information. When $\underline{k} \geq \theta$ the characterization of the equilibrium is trivial. Since either firm can cover total demand regardless of their realized capacities, Bertrand forces drive equilibrium prices down to marginal costs. For this reason, in the remainder of the paper we turn attention to the remaining cases. It is useful to start by assuming $\overline{k} \leq \theta$ (small installed capacities). In this case, a firm's capacity can never exceed total demand, implying that the low bid is always payoff irrelevant. We later analyze the case in which $\overline{k} > \theta$ (large installed capacities).
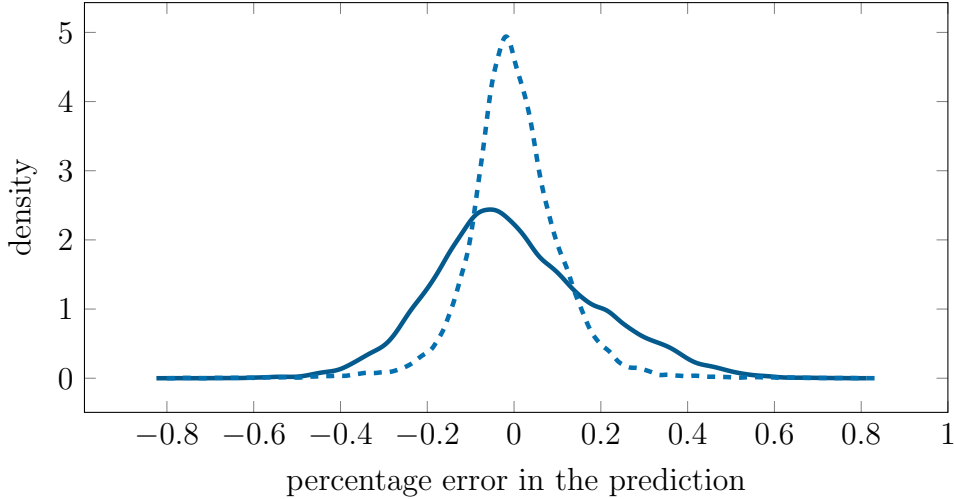
Figure 1: Kernel distribution of the forecasts errors using public (solid) or private information (dashed).

Note: This figure depicts the densities of the forecast errors of the specifications in Table 1. Both distributions are centered around zero, but the standard deviation is larger when only publicly available data are used.

3.1 Small Installed Capacities

We first consider the case of small installed capacities, defined as situations in which each firm's capacity never exceeds total demand, i.e., $\overline{k} \leq \theta$. Our first lemma identifies three key properties that any equilibrium must satisfy in this case.

Lemma 1. *If $\overline{k} \leq \theta$,*

(i) Capacity withholding is never optimal, $q_i^*(k_i) = k_i$.

(ii) All Bayesian Nash Equilibria must be in pure-strategies.

(iii) The optimal price offer of firm i, $b_i^*(k_i)$, must be non-increasing in k_i.

The first part of the lemma rules out capacity withholding in equilibrium.[19] The reason is that expected profits are strictly increasing in q_i: conditionally on having the low bid, the firm maximizes its output by offering to sell at capacity and, conditionally on having the high bid, its profits do not depend on its quantity offer as the firm always serves the residual demand. The probability of having the low bid does not depend on q_i. Furthermore, the market price remains unchanged with or without capacity withholding.

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[19]In case of indifference between withholding or not, we assume without loss of generality that the firm chooses not to withhold.

The second part of the lemma rules out non-degenerate mixed-strategy equilibria. The underlying reason is simple: a firm's profits at a mixed-strategy equilibrium depend on its realized capacity, which is non-observable by the rival. If the competitor randomizes in a way that makes the firm indifferent between two bids for a given capacity realization, the same randomization cannot make the firm indifferent for other capacity realizations as well. It follows that all equilibria must involve pure-strategies.

The last part of the above lemma rules out bids that are increasing in the firm's capacity. When a firm considers whether to reduce its bid marginally, two effects are at play for a given bid of the rival: a profit gain due to the output increase (*quantity effect*), and a profit loss due to the reduction in the market price (*price effect*). On the one hand, the *quantity effect* is increasing in the firm's capacity, as if it bids below the rival, it sells at capacity rather than just the residual demand. On the other hand, the *price effect* is independent of the firm's capacity as, contingent on bidding higher than the rival, the firm always sells the residual demand. Combining these two effects, the incentives to bid low are (weakly) increasing in the firm's capacity, giving rise to optimal bids that are non-increasing in k_i.[20]

Building on this lemma, we now turn to the characterization of the Bayesian Nash equilibria. For completeness, we describe both the asymmetric as well as the symmetric pure-strategy Bayesian Nash equilibrium of the game. We start with the former.

Proposition 1. *If $\overline{k} \leq \theta$, there exist asymmetric Bayesian Nash equilibria in pure-strategies, in all of which $p^* = P$. This market price is sustained by the following price-quantity pairs: $b_i^*(k_i) = P$ and $q_i^*(k_i) = k_i$, while $b_j^*(k_j) \leq \underline{b}$, where $\underline{b} > c$ and $q_j^*(k_j) = k_j$, for $i, j = 1, 2$ and $j \neq i$, with $\underline{b}$ low enough so as to make undercutting by firm i unprofitable.*

When firms' capacities never exceed total demand, there exist asymmetric equilibria in which one firm bids sufficiently low so as to discourage its rival from undercutting it. This firm is then forced to maximize its profits over the residual demand by bidding at the highest possible price, P.[21] The low bidder makes higher expected profits than the

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[20]The incentives to bid low are strictly increasing in the firm's capacity if marginally reducing the bid implies a strictly positive probability of increasing the firm's output, i.e., a strictly positive *quantity effect*. This need not be the case if the equilibrium is asymmetric, as we show below.

[21]If P were stochastic (either because it is interpreted as the marginal costs of the conventional producers or because it is the implicit price-cap that triggers regulatory intervention) the equilibrium

high bidder, as it sells at capacity rather than the residual demand. Therefore, firms are bound to face a coordination problem unless they can resort to an external correlation device. This might preclude them from playing the asymmetric equilibria, even though these equilibria allow firms to maximize joint profits.

We now focus on the characterization of the symmetric equilibrium. Using part (iii) of Lemma 1, we know that price offers must be non-increasing in capacity. In this case, however, and in contrast with the asymmetric equilibria characterized above, the optimal price offer at a symmetric equilibrium must be *strictly* decreasing in k_i. This result follows from standard Bertrand arguments: equilibrium bidding functions cannot contain flat regions, as firms would otherwise have incentives to slightly undercut those prices and expand the quantity sold with a strictly positive probability. This property allows us to write the expected profits of firm i using the inverse of the bid function of firm j, $b_j(k_j)$, as follows

$$\pi_i(b_i, b_j(k_j)) = \int_{\underline{k}}^{b_j^{-1}(b_i)} (b_j(k_j) - c)k_i g(k_j)dk_j + \int_{b_j^{-1}(b_i)}^{\overline{k}} (b_i - c)(\theta - k_j)g(k_j)dk_j.$$

When $k_j < b_j^{-1}(b_i)$, firm i has the low bid and sells up to capacity at the price set by firm j. Otherwise, firm i serves the residual demand and sets the market price at b_i.

Maximizing profits with respect to b_i and applying symmetry, we can characterize the optimal bid at a symmetric equilibrium.

Proposition 2. *If $\overline{k} \leq \theta$, at the unique symmetric Bayesian Nash equilibrium, each firm $i = 1, 2$ offers all its capacity, $q^*(k_i) = k_i$, at a price given by*

$$b^*(k_i) = c + (P - c)\exp\left(-\omega(k_i)\right), \tag{1}$$

where

$$\omega(k_i) = \int_{\underline{k}}^{k_i} \frac{(2k - \theta)g(k)}{\int_k^{\overline{k}}(\theta - k_j)g(k_j)dk_j}dk.$$

Equation (1) characterizes the optimal price offer for all capacity realizations. As anticipated, the optimal price offer adds a markup above marginal cost that is strictly decreasing in k_i. In order to provide some intuition, it is useful to implicitly re-write it

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market price would maximize the high bidder's profits, taking into account the distribution of P. Since the high bidder sells the expected residual demand, such a price is independent of the firm's realized capacity.

as follows

$$-\frac{b'^*(k_i)}{b^*(k_i) - c} = \omega'(k_i) = \frac{(2k_i - \theta)g(k_i)}{\int_{k_i}^{\overline{k}}(\theta - k_j)g(k_j)dk_j}. \tag{2}$$

This equation describes the incentives to marginally reduce the bid, which, in turn, reflect the trade-off between the *quantity effect* and the *price effect*, as captured by the ratio on the right-hand side of the above equation.

On the denominator, the price loss from marginally reducing the bid, or price effect, is only relevant when the firm is setting the market price, i.e., when the rival firm's capacity is above k_i. In this case, reducing the bid implies that the firm sells the expected residual demand, $\int_{k_i}^{\overline{k}}(\theta - k_j)g(k_j)dk_j$, at a lower market price. On the numerator, the output gain from marginally reducing the firm's bid, or quantity effect, is relevant only when the two firms tie in prices, i.e., when the rival also has capacity k_i, an event that occurs with probability $g(k_i)$. In this case, reducing the bid implies that the firm sells all its capacity rather than just the residual demand, i.e. its output expands in the amount $k_i - (\theta - k_i) = 2k_i - \theta$.

The ratio of these two effects shape the form of the bidding function as described in the left-hand side of equation (2). A bigger quantity effect increases a firm's incentives to undercut the rival, meaning that in order to sustain this symmetric equilibrium the bidding function must become steeper — to require a larger bid reduction — and the mark-up must become smaller — to make undercutting less profitable. A smaller price effect, to the extent that it makes price increases less relevant, has a similar effect.

The optimal bid starts at P for the lowest possible capacity realization and ends at c for the largest one. When $k_i = \underline{k}$, firm j is bigger by construction, so firm i sets the market price with probability one. A price offer below P could never be part of an equilibrium as firm i could sell the same output at a higher price by bidding at P. When $k_i = \overline{k}$, firm j is smaller by construction, so firm i never sets the market price. Hence, the firm's bid has no impact on the price and only the quantity effect matters. Therefore, a price offer above c could never be part of an equilibrium as firm i would increase the expected sales at the same price by bidding at c. Figure 4 illustrates the equilibrium price offer as a function of k_i.

Finally, given equilibrium bidding, each firm's expected profits are equal to the minimax when $k_i = \underline{k}$, and they are strictly higher otherwise. The reason is simple: a firm can always pretend to be smaller by withholding output and replicating the smaller firm's
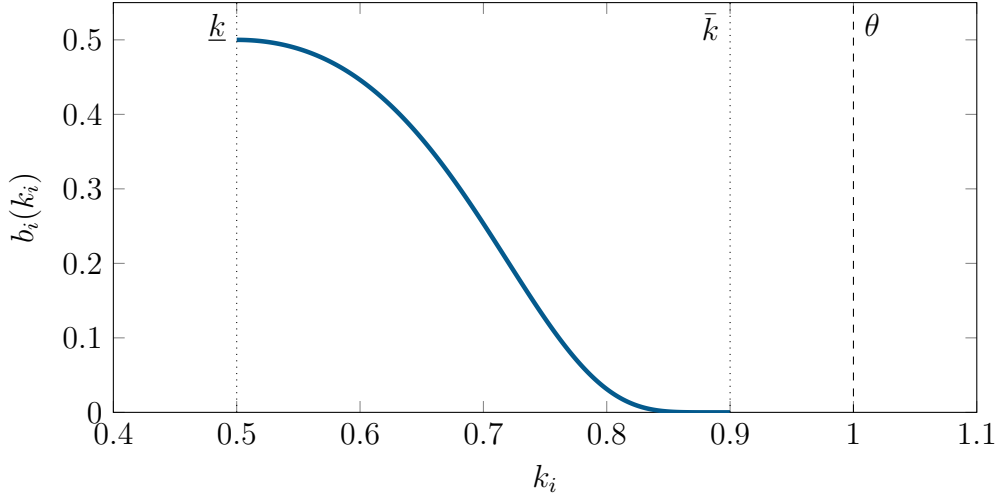
16

Figure 2: Equilibrium price offer

Note: This figure depicts the equilibrium price offer as a function of k_i when $k_i \sim U[0.5, 0.9]$, with $\theta = 1$, $c = 0$, and $P = 0.5$. One can see that it starts at P for $k_i = \underline{k}$, and that it decreases in k_i until it takes the value $c = 0$ at $k_i = \overline{k} = 0.9$.

bid. The fact that firms prefer to offer all their capacity means that larger firms make higher equilibrium profits than the smallest one, whose profits exactly coincide with the minimax. As a result, expected equilibrium market prices are higher than when firms just obtain their minimax. This insight will become useful in Section 4, where we compare equilibrium prices when capacities are private information or unknown to both firms.

3.2 Large Installed Capacities

We now analyze the case of large installed capacities in which a single firm's capacity might exceed total demand, $\overline{k} > \theta$. In contrast with the case of small installed capacities, withholding is now optimal for firms whose capacity exceeds total demand, $k_i > \theta$, as shown in the following proposition.

Proposition 3. *If $\overline{k} > \theta$, in equilibrium, $b_i^*(k_i) = c$ and $q_i^*(k_i) = \theta$ for all $k_i > \theta$, $i = 1, 2$. For $k_i \leq \theta$, Propositions 1 and 2 apply with k_i replaced by $q_i^*(k_i)$, $i = 1, 2$.*

For capacity realizations $k_i \leq \theta$, equilibrium bidding is just as in the case with small installed capacities. However, for $k_i > \theta$, offering to supply k_i is weakly dominated by offering to supply θ: in any event, the firm will never produce more than θ and, conditioning on having the low price, offering θ instead of k_i increases the chances that the rival's higher price offer will set the market price.[22] For these reasons, the equilibrium

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[22]If instead of setting the market price at the lowest non-accepted bid, we set it equal to the highest

characterization is identical to the one in the previous propositions, the only difference being that the relevant distribution has a mass point at θ, i.e., the distribution remains unchanged for $k_i \leq \theta$ but $G(\theta) = 1$. Note that withholding increases the market price but it implies no distortion in the quantity sold given that the withheld capacity would never have been used.[23]

An interesting insight from our model is that capacity realizations determine endogenously whether firms compete *à la* Cournot - with firms withholding capacity - or *à la* Bertrand - with firms offering all their capacity at prices above marginal costs.

3.3   Implications for Market Performance

Combining Sections 3.1 and 3.2, we can now shed light on two issues: (i) how do prices change when demand goes up, relative to existing capacities?, and (ii) how will prices change as total investment increases?

Regarding the first issue, equilibrium price offers shift out as demand increases since the quantity effect becomes less important, i.e., the quantity gain when undercutting the rival is smaller since the residual demand is bigger. Consequently, equilibrium prices go up when demand increases relative to existing capacities. In practice, this implies that, even controlling for available capacities, the response of mark-ups to demand movements adds another source of market price volatility. If demand shocks are positively (negatively) correlated with capacity shocks, price volatility is softened (amplified). To the extent that the available capacities of the various production technologies have different correlation with demand, their impact on market power and the price patterns differ.

Regarding the second issue, an increase in installed capacity κ implies a parallel increase in the capacity bounds $\underline{k} = \beta\kappa + \underline{\varepsilon}$ and $\overline{k} = \beta\kappa + \overline{\varepsilon}$. As this increases the probability that capacity exceeds θ, firms are more likely to bid at c. In turn, this implies that the expected market price smoothly converges towards marginal costs. Eventually, as $\underline{k}$ reaches θ, the market becomes competitive at all times as the equilibrium bid function

accepted bid, firm i would optimally offer to produce a quantity slightly below total demand, θ, giving rise to the same market price and (almost) the same quantity allocation.

[23]This result is robust to the introduction of small amounts of demand uncertainty. Suppose that θ is distributed in $[\underline{\theta}, \overline{\theta}]$. An equilibrium with withholding would have firm i offering $q_i = \underline{\theta}$ at marginal costs whenever $k_i > \underline{\theta}$. Deviating to $q_i' > \underline{\theta}$ would allow the firm to increase production by $q_i' - \underline{\theta}$, but this would also drive the market price down to marginal costs if $\theta < q_i'$. If demand uncertainty is sufficiently small, the quantity loss from withholding up to $\underline{\theta}$ is smaller than the price loss, implying that the equilibrium with withholding would be preserved.
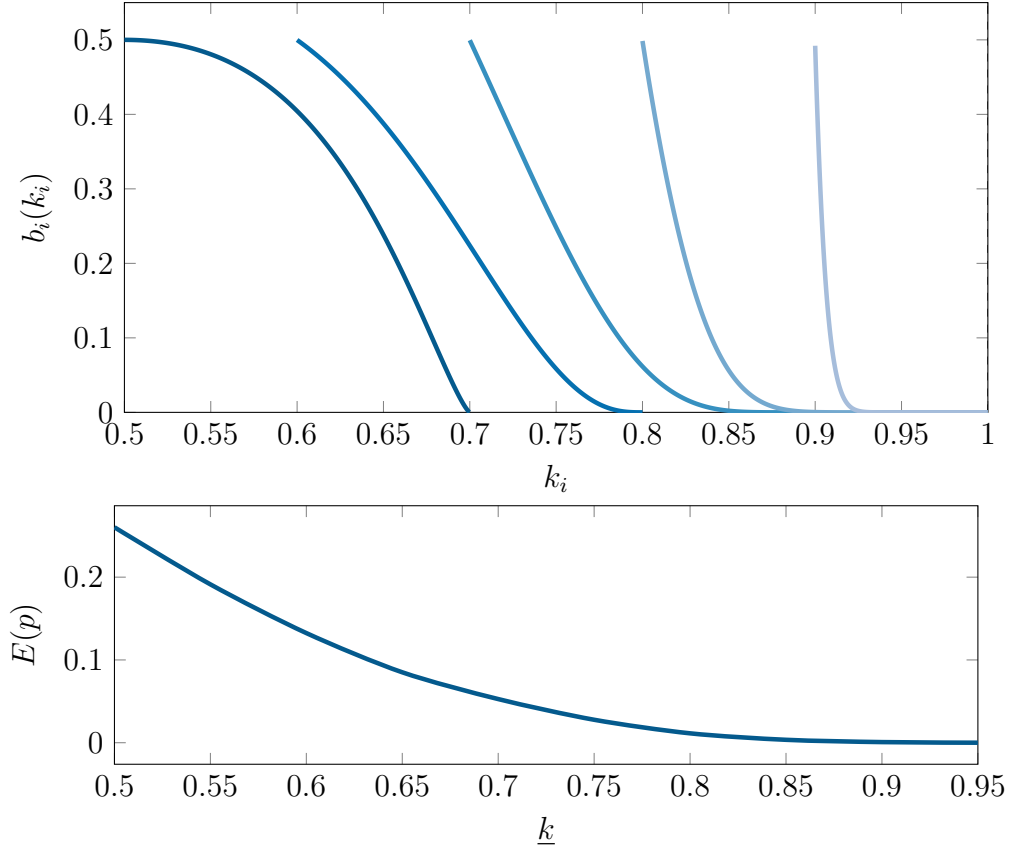
Figure 3: Equilibrium price offers and expected market price as installed capacity increases

Note: The upper panel shows that the equilibrium price offers shift outwards as κ, and consequently, $\underline{k}$ increases. The lower panel shows that the expected market price smoothly goes down as a function of $\underline{k}$, which together with $\overline{k}$, shift out as κ increases. The figures assume $\theta = 1$, $c = 0$, and $P = 0.5$, and $k_i \sim U[\underline{k}, \underline{k} + 0.2]$, for $\underline{k} \in [0.5, 0.95]$.

puts almost all the mass at marginal cost.

This exercise is illustrated in Figure 3. As can be seen in the upper panel, increases in κ, which are represented with lighter colors, shift firms' equilibrium price offers to the right. This change is driven by a stronger *price effect*, as for a given realization of k_i, the rival's capacity is expected to be larger and, hence, firm i is more likely to set the market price. However, this is more than compensated by the effects of having more installed capacity: since higher capacity realizations become more likely, equilibrium market prices decrease, as illustrated in the lower panel of the figure.

4 What is the impact of private information?

In this section we aim to understand the effect of private information on bidding behavior and market outcomes. For this purpose, we first characterize equilibrium outcomes under two benchmarks with no private information, either because capacities are publicly known or because they are unknown to both firms prior to bidding. We focus our analysis in the comparison of the ex-ante symmetric equilibria. The asymmetric equilibria characterized in Proposition 1 could be sustained under all three informational assumptions and, therefore, the comparison would be uninteresting.

First, suppose that firms observe realized capacities prior to submitting their price offers. Accordingly, firms' bids can be conditioned on realized capacities and withholding is possible as in the private information case. The following lemma characterizes the level of profits that can be sustained by symmetric equilibria, either in pure or in mixed-strategies.

Lemma 2. *Suppose that realized capacities are publicly known prior to bidding:*

(i) *If $k_i < k_j$, there exist symmetric pure-strategy Nash equilibria, resulting in joint profits $(P-c)\theta$. There also exist symmetric mixed-strategy Nash equilibria, resulting in expected joint profits bounded from above by $(P-c)\theta$ and from below by $(P-c)(2\theta - k_i - k_j)$ if $k_i + k_j < 2\theta$ and 0 otherwise.*

(ii) *If $k_i = k_j = k$, the unique symmetric Nash equilibrium is in mixed-strategies. It yields expected joint profits $2(P-c)(\theta - k)$ if $k < \theta$ and 0 otherwise.*

The game with known capacities allows firms to sustain equilibria in which all their output is sold at P. Just as we described in Section 3, these equilibria are characterized by asymmetric bidding. One firm bids at P while the rival bids low enough so as to make undercutting unprofitable. This holds true even if $k_i > \theta$ as in this case firms can escape Bertrand pricing by withholding output and choosing $q_i(k_i) = \theta$.[24] The main difference between this game and the one in which capacities are private information is that firms can use realized capacities (if they are asymmetric) to overcome their coordination problem. For instance, they can now share profits symmetrically by designating the small firm to

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[24]Note that if $k_i > \theta$, Fabra et al. (2006) predict Bertrand competition because, unlike us, they do not allow firms to choose both prices and quantities.

bid low and the large firm to bid high.[25] Therefore, when realized capacities are publicly known (and asymmetric), there exist symmetric equilibria that allow firms to obtain maximum profits.

The game with publicly known (and asymmetric) capacities also gives rise to a continuum of mixed-strategy equilibria, with firms randomizing their bids between P and c. In one of the extremes, equilibrium profits are lowest when firms do not condition their bidding on realized capacities. In this case, the mixed-strategy equilibrium involves no firm playing a mass point at P. In the other extreme, equilibrium profits are the highest when one of the firms plays P with probability almost equal to one, thus converging to the pure-strategy equilibrium characterized above. In turn, this shows that all the mixed-strategy equilibria are Pareto-dominated by the pure-strategy equilibrium.

Consider now the case in which firms do not observe realized capacities prior to bidding. For comparison purposes, we consider a slightly different game in which firms make their price offers before capacities are realized, but they make their quantity offers after observing their realized capacity. The same results would arise if, instead, firms commit to sell all their capacity at the chosen price once capacities are realized. The following lemma shows that the unique symmetric equilibrium involves mixed-strategy pricing.

Lemma 3. *If realized capacities* (k_i, k_j) *are known after firms have made their price offers, the unique symmetric Bayesian Nash equilibrium involves mixed strategies, with firms randomizing their prices in the interval* (c, P). *Expected equilibrium joint profits are* $2(P - c)\left[\theta - E(k|k \leq \theta)\right]$.

After prices are chosen and capacities have been realized, firms have the same withholding incentives as in the previous cases. In particular, they find it optimal to offer all their capacity if it is lower than θ, and to offer to supply θ otherwise. As a result, since price offers cannot be conditioned on capacities, in a symmetric equilibrium, both firms would either charge equal prices or use the same mixed-strategy to randomize their prices. The former is ruled out by standard Bertrand arguments, implying that the only symmetric equilibrium involves mixed-strategies. Since at P the rival firm is bidding below with probability one, and since all the prices in the equilibrium support yield equal

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[25]The only exception is when firms' realized capacities are equal. If firms can condition on an external correlation device, they can still share profits symmetrically. Otherwise, the unique symmetric equilibrium involves mixed-strategy pricing, with firms making (weakly) lower expected profits.

expected profits, it follows that at the unique symmetric equilibrium each firm makes expected profits equal to $(P-c)(\theta - E[k|k \leq \theta])$. Notice that $E[k|k \leq \theta]$ is the expected production of the low bidder taking into account the optimal withholding decision.

We are now ready to rank expected prices at the symmetric equilibria across all three information treatments.

Proposition 4. *The comparison of the symmetric Bayesian Nash equilibria in the games in which capacities are unknown, private information, or publicly known, shows that:*

(i) The lowest expected prices are obtained with unknown capacities.

(ii) The highest expected prices are obtained with publicly known capacities.

The proposition above shows that the more information firms have, the higher the expected prices they can obtain at a symmetric equilibrium. When capacities are private information, the fact that bidding incentives differ across firms allows them to avoid fierce competition, but not as much as if both capacities were known: large (small) firms find it in their own interest to bid low (high), but not as low (high) as if they knew with certainty that the rival firm was bidding higher (lower). When capacities are unknown to both firms, they face fully symmetric incentives and they end up competing fiercely. As a result, private information leads to higher prices than in the case with unknown capacities, but lower than when capacities are publicly known. Indeed, firms would be better off if they could exchange their private information regarding their available capacities.[26] For the same reason, in the context of electricity markets, system operators should avoid publishing individual firm production capacities even if, in practice, they collected it to construct an aggregate forecast.

The above results serve to shed some light on the relationship between the precision of information and equilibrium bidding. In our model, when firms get a very precise signal about the rival's capacity, equilibrium profits converge to those with symmetric and known capacities, for which the symmetric equilibrium involves mixed-strategies that give rise to very low profits (i.e., reaching the minimax).

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[26]In fact, in our model firms would have unilateral incentives to share the realization of their own capacity with the rival, as this allows them to better coordinate and sustain higher equilibrium profits. The debate on the incentives for information transmission between firms dates back to classical papers like Vives (1984) and Gal-or (1986). Brown et al. (2018) describe recent cases illustrating the discussion on the effects of increased transparency in electricity markets.

However, this result is misleading as it only applies to instances when firms are ex-post symmetric, an event that occurs with zero probability. More generally, the model developed so far does not allow to disentangle the effects of improved information precision from those of increased symmetry: as the precision of the signal increases, not only firms become better informed about the rival's capacity but also their capacities are more likely to become ex-post symmetric. Since increased symmetry leads to more competitive outcomes, this latter effect confounds the true impact of information on bidding behavior.[27]

Accordingly, in order to understand the effects of information precision in our model, we need to work with ex-ante asymmetric capacities. While we perform a formal analysis of this case in Section 5.1, some of its conclusions are pertinent for the current discussion. Suppose that k_i is uniformly distributed in $[\underline{k}_i, \overline{k}_i]$, with $\underline{k}_1 > \overline{k}_2$, i.e., firm 2 is always smaller than firm 2. In this case, there cannot exist equilibria similar to those in Proposition 2 as there is no uncertainty on which firm has the small capacity and hence the high bid. As a consequence, the only pure-strategy Bayesian Nash equilibria are those in Proposition 1, with $p^* = P$. In words, the introduction of a small amount of uncertainty around asymmetric capacities has no impact on bidding behavior or market outcomes. However, adding more uncertainty so that firms' capacity intervals overlap, $\overline{k}_2 > \underline{k}_1$, gives rise to equilibria in which firms' bids are a function of realized capacities (along the lines of Proposition 2). As in Proposition 4, the expected market price starts falling below P as the forecasts about the rival's capacity become more noisy. In sum, the less precise the signal about the rival's capacity, the weaker is market power, in line with our previous conclusions regarding the impact of private information.

5 Extensions and Variations

In this section we consider extensions and variations of the baseline model. First, we entertain changes in the market structure: we introduce asymmetries across firms and we

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[27]This question has already been addressed in other contexts. Spulber (1995) showed that introducing asymmetric information on firms' costs in the standard price competition model leads to higher prices. However, the opposite conclusion is reached when comparing a game with private information on costs versus one in which costs are known but they are stochastic, using the same distribution (Hansen, 1988). Lagerlöf (2016) shows that the convergence between both models occurs not because of an increase in the precision of the signal that firms receive but, rather, due to an increasing affiliation of the costs shocks. That is, private information on costs mitigates market power, in line with our model's predictions regarding the impact of private information on capacities.

allow for more than two symmetric firms. Second, we consider a change in the market design: we analyze the effects of banning capacity withholding.

5.1 Asymmetric Firms

We now discuss the case in which firms have ex-ante different capacities. In particular, firm i has capacity $k_i = \beta \kappa_i + \varepsilon_i$ with $\kappa_1 > \kappa_2$. For simplicity, we assume that errors are uniformly distributed in a common interval $[\underline{\varepsilon}, \overline{\varepsilon}]$, so that the capacity of firm i is uniformly distributed between $\underline{k}_i = \beta \kappa_i + \underline{\varepsilon}$ and $\overline{k}_i = \beta \kappa_i + \overline{\varepsilon}$ for $i = 1, 2$. As in Section 3, we assume that firms' aggregate capacity is always enough to cover total demand, $\underline{k}_1 + \underline{k}_2 \geq \theta$.

We start with the case in which the two firms' installed capacities are small, $\overline{k}_1 \leq \theta$.

Proposition 5. *Assume that k_i is uniformly distributed in $[\underline{k}_i, \overline{k}_i]$. If $\overline{k}_1 \leq \theta$, in equilibrium each firm offers all its capacity, $q_i^*(k_i) = k_i$ for $i = 1, 2$. Furthermore:*

(i) *The asymmetric pure-strategy Bayesian Nash equilibria characterized in Proposition 1 continue to exist.*

(ii) *Moreover, if $\overline{k}_2 \geq \underline{k}_1$, there also exists an equilibrium in which price offers are characterized as*

$$b_i^*(k_i) = \begin{cases} P & \text{if } \underline{k}_2 \leq k_i \leq \underline{k}_1, \\ b^*(k_i) & \text{if } \underline{k}_1 < k_i < \overline{k}_2, \\ c & \text{if } \underline{k}_1 \leq k_i \leq \overline{k}_1, \end{cases}$$

where

$$b^*(k_i) = c + (P - c) \exp\left(-\omega(k_i)\right), \tag{3}$$

and

$$\omega(k_i) = \int_{\underline{k}_1}^{k_i} \frac{(2k - \theta)}{\int_k^{\overline{k}_2} (\theta - k_j) dk_j} dk.$$

Interestingly, this proposition shows that ex-ante capacity asymmetries move equilibrium bidding behavior from Proposition 2 to Proposition 1. When the capacity intervals do not overlap, $\overline{k}_2 < \underline{k}_1$, the equilibria are identical to the ones characterized in Proposition 1, with one firm setting the market price at P and the other one choosing a sufficiently low bid. There cannot exist a symmetric equilibrium like the one in Proposition 2, as it relies on firms being uncertain about the identity of the large firm and, therefore, about the identity of the low bidder.
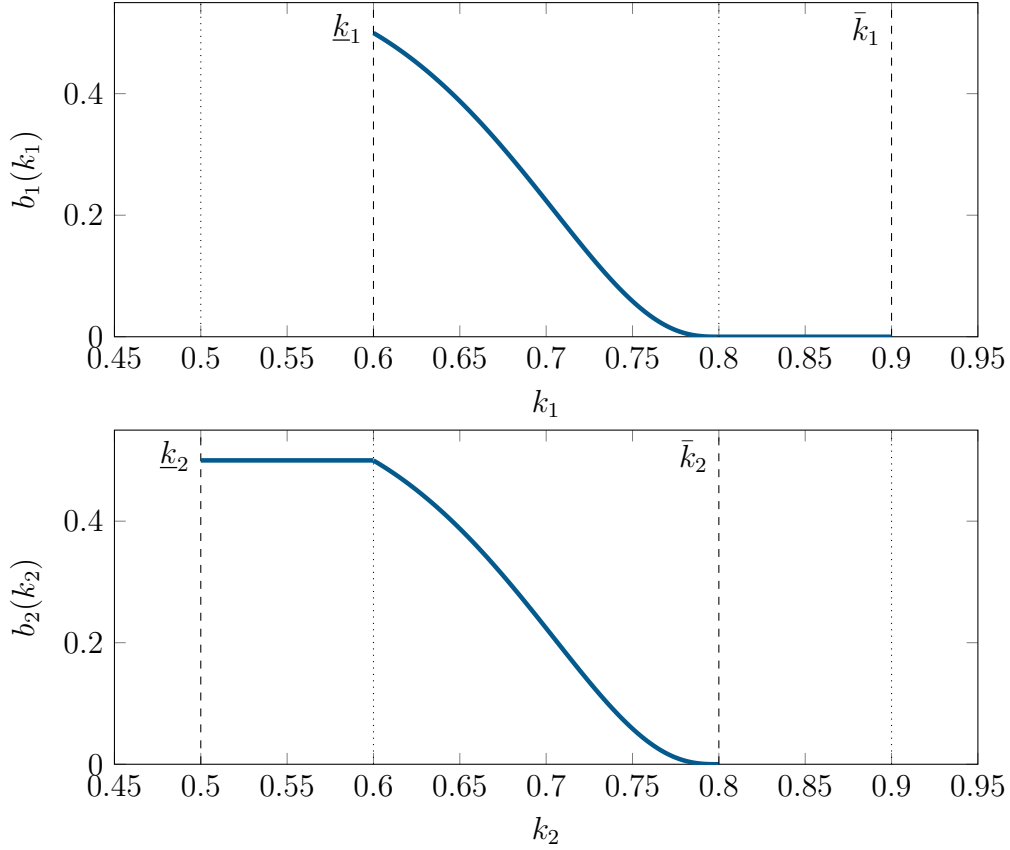
Figure 4: Equilibrium price offers when firms are ex-ante asymmetric

Note: This figure depicts the equilibrium price offers as a function of k_i when $k_1 \sim U[0.6, 0.9]$ and $k_2 \sim U[0.5, 0.8]$, $\theta = 1$, $c = 0$, and $P = 0.5$. One can see that the equilibrium is symmetric only in the area of capacity overlap, $[0.6, 0.8]$. For larger capacities $[0.8, 0.9]$, the large firm bids at c (upper panel), whereas for smaller capacities $[0.5, 0.6]$, the small firm bids at P (lower panel).

In contrast, when the capacity intervals overlap, this uncertainty reemerges for capacities in the range $[\underline{k}_1, \overline{k}_2]$. Over this interval, the equilibrium price offers resemble those in Proposition 2, with firms pricing at P for $k_i = \underline{k}_1$ and at c for $k_i = \overline{k}_2$. For smaller capacity realizations, firm 2 bids at P. For higher capacity realizations, firm 1 bids at c. As a result, both price offers are continuous in the realized capacities. Figure 4 illustrates these bids.

These equilibria survive in the large installed capacities case when capacity withholding becomes optimal, as stated next.

Corollary 1. *If $\overline{k}_1 > \theta$, in equilibrium each firm offers $q_i^*(k_i) = \min\{\theta, k_i\}$ and prices according to Proposition 5, where the relevant threshold in part (ii) of Proposition, $\overline{k}_2$, is replaced by $\min\{\theta, \overline{k}_2\}$.*

For the same reasons explained in the ex-ante symmetric capacities case, firms always

find it optimal to withhold capacity whenever their realized capacity exceeds θ. As a result, firms behave in equilibrium as if their capacities were capped with a mass point at θ.

This equilibrium characterization allows us to conclude that, keeping aggregate installed capacity as given, an increase in firms' asymmetry results in higher expected prices. As firm 2 becomes smaller in expected terms, it bids at P with a higher probability, raising the expected equilibrium price. In the limit, when asymmetries are such that there is no capacity overlap, $\underline{k}_1 > \overline{k}_2$, the market price is P with probability 1.

It is important to notice, however, that the characterization of this equilibrium hinges on the density of each firm being identical in the range of capacity overlap, thanks to the assumption of uniformly and identically distributed idiosyncratic shocks. This guarantees that the two first order conditions that characterize optimal bidding are identical, allowing us to conclude that the equilibrium price offers are symmetric. While we do not provide a characterization for generic distribution functions, we conjecture that the nature of the equilibrium would remain similar but explicit solutions would be unlikely to come by.

5.2 N Firms

We now extend our equilibrium analysis to accommodate an arbitrary number of symmetric firms, $N \geq 2$. As in Section 3, we assume that firms always have enough aggregate capacity to cover total demand, $N\underline{k} \geq \theta$. For simplicity, we focus our discussion on the case of small installed capacities and assume that all firms are always necessary to cover demand. As a result, all firms but the one with the highest bid will sell at capacity. From the point of view of firm i, this means that the N-firm problem can be reinterpreted as if each firm was only facing one competitor, the smallest one.

We introduce some additional notation. Let k_{-i} be the minimum capacity among those of firm i's rivals, i.e., $k_{-i} = \min_{j \neq i} k_j$. As usual, its cumulative distribution function and density are

$$
\begin{aligned}
\Phi\left(k_{-i}\right) &= 1 - \left(1 - G\left(k_{-i}\right)\right)^{N-1}, \\
\varphi\left(k_{-i}\right) &= \left(N - 1\right) g\left(k_{-i}\right) \left(1 - G\left(k_{-i}\right)\right)^{N-2}.
\end{aligned}
$$

The following result characterizes the equilibrium behavior in this case.

Proposition 6. *When* $(N-1)\overline{k} \leq \theta$, *at the unique symmetric Bayesian Nash equilibrium, each firm* $i = 1, .., N$ *offers all its capacity,* $q^*(k_i) = k_i$, *at a price given by*

$$b^*(k_i) = c + (P - c)\exp\left(-\omega(k_i)\right),$$

where

$$\omega(k_i) = \int_{\underline{k}}^{k_i} \frac{\left(2k + \int_k^{\overline{k}}(N-2)\,kg(k)dk - \theta\right)\varphi(k)}{\int_k^{\overline{k}}\left(\theta - k_j - \int_{k_j}^{\overline{k}}(N-2)\,kg(k)dk\right)\varphi(k_j)dk_j}dk.$$

As compared to the solution in the duopoly case, N enhances the quantity effect because the gain in production from marginally reducing the bid is stronger the more competitors there are in the market. At the same time, the price effect is weakened because the reduction in the market price only affects the firm's residual demand, which is smaller the higher is N. Both effects imply that the optimal price offer goes down with N and so does the equilibrium price.[28]

The previous analysis is relevant to study the effects of entry, as an increase in the number of firms brings in additional capacity. However, studying the effects of mergers or divestitures requires keeping total capacity fixed. Otherwise, the effects of changing the number of firms would be confounded with those of changing the amount of installed capacity.

Accordingly, consider now a situation where an even number of single-plant firms N merge into $N/2$ firms, each one owning two plants. Since total capacity remains the same, the difference between these two cases is solely due to the plants' ownership structure. Two effects arise. On the one hand, there is a *size effect*. As mergers make firms bigger, they tend to behave less competitively. On the other hand, there is a *capacity-distribution effect*. Mergers change the distribution of capacity across firms, thus affecting their bidding incentives. After the merger, each firm bids according to the sum of its two plants' realized capacities whereas before the merger, each firm bids according to its single plant's realized capacity. Since firms care about the bid of their relevant competitor, after the merger each firm cares about the sum of its rival's plants' realized capacities, while before the merger each firm cares about the smallest plant's realized

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[28]The characterization of the equilibria in cases with $(N - 1)\overline{k} > \theta$ is more cumbersome and yet it provides similar insights. When firms might have larger capacities the quantity that each one sells not only depends on whether it is the smallest firm and, therefore, it sells the residual demand, but it could also occur when the firm has the second smallest capacity, the third smallest, and so on. Mathematically, this requires the usage of higher order statistics and not only the first one.
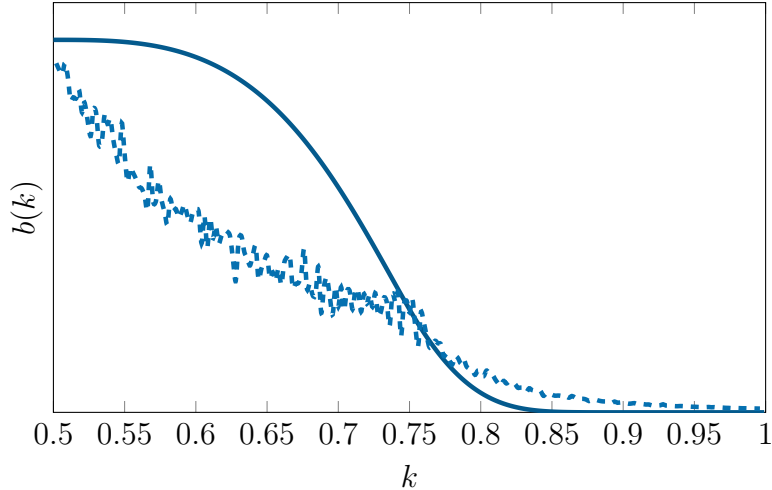
Figure 5: Equilibrium effective bids for $N = 2$ and $N = 4$.

Note: Each plant's capacity is uniformly distributed, $k_i \sim U[0.25, 0.5]$. For the case $N = 2$, the solid line depicts the equilibrium bid of a firm whose two plants' capacities sum k. For the case $N = 4$, the dashed line depicts the maximum equilibrium bid across two firms whose plants' capacities sum k. Since there are several combinations of the two plants' capacities summing k, the dashed line represents the average across all such combinations. The remaining parameters are $c = 0$, $P = 0.5$ and $\theta = 1$.

capacity. The distribution of the sum tends to put more weight on intermediate capacity values as smaller realizations of one plant are compensated with larger realizations of another. As a consequence, this effect induces the merged multi-plant firms to behave more aggressively as they expect their rival to submit lower bids with higher probability.

Figure 5 provides an illustration of how the previous two forces shape the equilibrium with $N = 2$ as compared to $N = 4$. Suppose there are four plants. The capacity of each plant is uniformly distributed between $[0.25, 0.5]$. Since total demand is equal to 1, the production of all four plants is necessary to cover demand. When $N = 2$ and each firm owns two plants, firms care about the rival's total realized capacity, which follows a triangular distribution in $[0.5, 1]$. When $N = 4$ and each firm owns a single plant, the relevant competitor is the one with the smallest realized capacity, given that it will submit the highest bid. The equilibrium price offer in the case $N = 2$ when a firm's realized capacity is k is represented in Figure 5 by a solid line. To make the case $N = 4$ comparable with the case $N = 2$, we also compute the highest bid in the case $N = 4$ when total capacity adds up to k.[29] As there are several combinations of firms' capacities

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[29]Formally, this expression can be computed as

$$\hat{b}(k) = \int_{\underline{k}}^{\overline{k}} \max[b(k_i), b(k - k_i)] g(k_i) g(k - k_i) dk_i.$$

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adding up to k, the figure represents with dots the average highest bid for each k.

As the figure shows, the merger translates into higher bids only when realized capacity is small (as the *size effect* dominates), whereas the reverse is true when realized capacity is high (as the *capacity distribution effect* dominates). However, the equilibrium market price is higher in the $N = 2$ case, thus suggesting that, in expected terms, the size effect tends to dominate over the capacity distribution effect.

5.3   Capacity Withholding is not Allowed

In Section 3.2 we showed that the symmetric equilibrium involves capacity withholding whenever $k_i > \theta$. A natural question arises: should a regulator ban capacity withholding? Indeed, market rules in some countries discourage firms from doing so.[30] What would equilibrium bidding behavior look like in that case? Does a ban on capacity withholding benefit consumers? To address these questions, we now characterize equilibrium bidding when capacity withholding is not possible and compare it with the one reported in Proposition 2.

The constraint $q_i = k_i$ is clearly not binding in the case of small installed capacities, $\overline{k} \leq \theta$, as firms never find it optimal to withhold capacity even if allowed (Lemma 1). In contrast, banning capacity withholding in cases with $\overline{k} > \theta$ has a dramatic impact on bidding incentives.

To understand why, consider first the case in which firm i is not capacity constrained to serve total demand, i.e., $k_i > \theta$. Unlike cases with $k_i \leq \theta$, the firm's bid is pay-off relevant even when it turns out to be the low one. This induces the firm to charge higher prices, knowing that with some probability it will serve total demand at is own price. However, this leads to a countervailing effect. In particular, the optimal bids for capacity realizations $k_i < \theta$ are now lower than in the model with withholding given that the firm is more likely to be the low bidder (note that if the rival's capacity exceeds θ, the rival's bid is above, rather than equal to, marginal costs).

Interestingly, if $k_i > \theta$, the firm's expected profits do not depend on its realized capacity. Maximum profits could thus be attained if, in equilibrium, firms charged the same price for all capacity realizations above θ. However, if they did so, ties would

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[30]The German case provides a related example (May, 2017). Since 2000, payments to wind plants are adjusted to the local wind resource (the worse the site, the higher the remuneration). Since 2007, the wind classification is set according to the potential rather than the actual output. Firms' incentives to withhold output in order to obtain a higher remuneration have been mitigated as a result.

occur with positive probability, but this is ruled out in equilibrium (for similar reasons as before). Hence, at a symmetric equilibrium, firms must choose different bids for different capacity realizations. One option is for firms to use their realized capacities as an internal randomization device, leading to a pure-strategy Bayesian Nash equilibrium. Clearly, for firms to be willing to do so, it must be the case that all bids that are chosen when $k_i > \theta$ lead to the same expected profits, given the rival's strategy. This is the case in the pure-strategy Bayesian Nash Equilibrium of the game with no capacity withholding, which is characterized next.

Proposition 7. *Assume $\overline{k} > \theta$. All symmetric Bayesian Nash Equilibrium without capacity withholding are outcome equivalent to firm i choosing a quantity offer $q_i^* = k_i$, and a price offer characterized as follows:*

(i) *For $k_i \in \left[\underline{k}, \hat{k} \right]$ and $k_i \in \left[\tilde{k}, \theta \right]$, the optimal price offer is $b^*(k_i)$, as defined in (1) with $\overline{k}$ replaced by θ.*

(ii) *For $k_i \in \left(\hat{k}, \tilde{k} \right)$, the optimal price offer is $\hat{b}(k_i)$, which is strictly decreasing in k_i and strictly lower than $b^*(k_i)$ as defined in (1), with $\overline{k}$ replaced by θ.*

(iii) *For $k_i > \theta$, firm i chooses a bid $b(k_i)$ in a support $\left[\underline{b}, \overline{b} \right]$, where $\underline{b} > c$ and $\overline{b} < P$. Firms' expected profits are the same for all bids in the support, for all $k_i > \theta$.*

The thresholds $\hat{k}$ and $\tilde{k}$ are implicitly defined as $b^*(\hat{k}) = \overline{b}$ and $b^*(\tilde{k}) = \underline{b}$.

One distinctive feature of this equilibrium is that it is non-monotonic in k_i, particularly so around θ. The optimal bid converges to c to the left of θ as the firm is certain to be selling at capacity at the price set by the rival. In contrast, the bid jumps above c when $k_i > \theta$, as the firm is aware that its bid is always payoff relevant. Also note that, for capacity realizations above θ, firms charge prices strictly below P. The reason is that they face a downward sloping residual demand, induced by the downward sloping bid function of the rival when its capacity realization is below θ.

In the previous proposition, when $k_i > \theta$ firms choose different bids for realizations of k_i that are payoff irrelevant. As a result, the equilibrium strategy is undetermined. However, all the candidate equilibrium strategies have to lead to a unique distribution of bids when $k_i > \theta$, which we denote as $F(b)$. Given this distribution, the rival firm is indifferent between any bid in the support for all $k_i > \theta$. An equivalent alternative
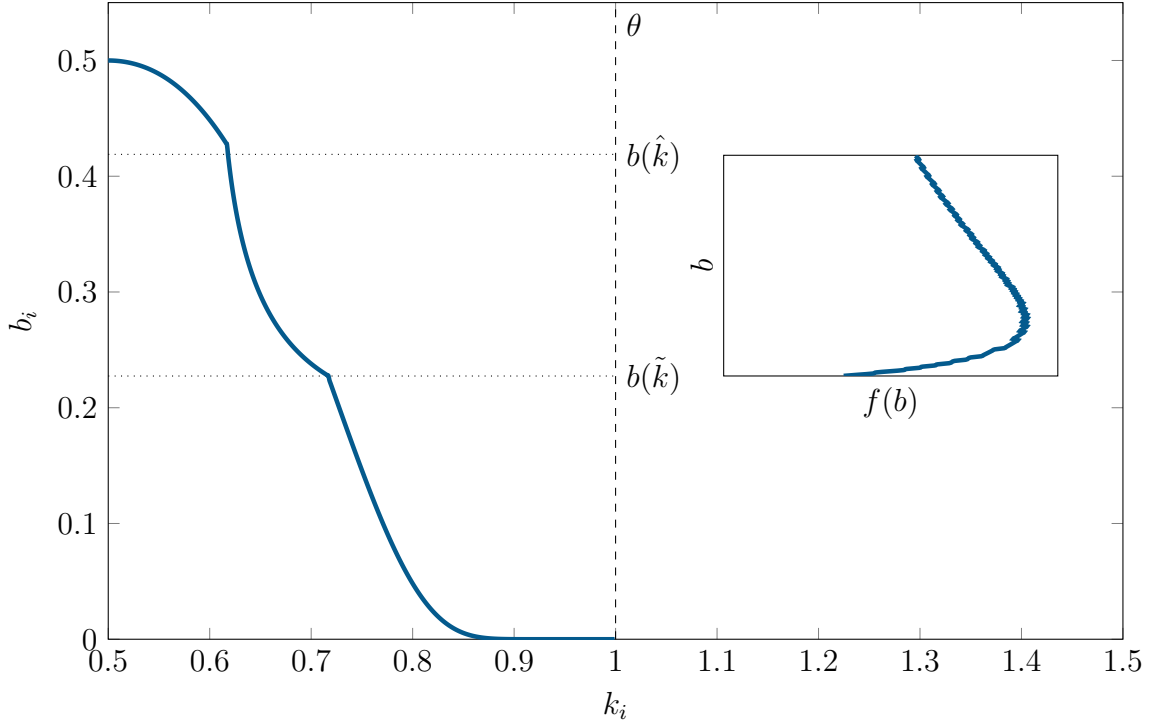
Figure 6: Equilibrium price offers when capacity withholding is not allowed.

Note: The figure depicts the equilibrium price offer. The equilibrium involves a pure-strategy for capacities below θ and a mixed-strategy for capacities above θ (the price density is depicted on the right). Parameter values $k_i \sim U[0.5, 1.1]$, with $\theta = 1$, $c = 0$, and $P = 0.5$.

in line with Harsanyi's Purification Theorem (Harsanyi, 1973) is for firms to randomize their bids using an external randomization device independently of the realization of k_i, just as in a mixed-strategy equilibrium. In the rest of this section and for illustration purposes we focus on this equilibrium.

As it can be observed in the example illustrated in Figure 6 the optimal bid when k_i belongs to either $\left[\underline{k}, \hat{k}\right]$ or $\left[\tilde{k}, \theta\right]$ is similar to the one when capacity withholding is allowed. The sole difference is that, from firm i's point of view, firm j's relevant capacities now range from $\underline{k}$ to θ given that firm i's profits are constant when $k_j > \theta$. In particular, for such capacities, firm j randomizes its bid in the support $(\underline{b}, \bar{b})$ and, thus, price offers are bounded from above by $b^*(\hat{k}) = \bar{b}$ and from below by $b^*(\tilde{k}) = \underline{b}$. Hence, if $k_j > \theta$, firm i does not produce anything if k_i belongs to $\left[\underline{k}, \hat{k}\right]$, while firm i sells at capacity at the price set by firm j if k_i belongs to $\left[\tilde{k}, \theta\right]$. It follows that whenever $k_j > \theta$, firm i's bidding incentives are equal to those in Proposition 2 with $\bar{k} = \theta$.

This result is in contrast to the case with $k_i \in \left[\hat{k}, \tilde{k}\right)$. For these realizations, firm i might have the low or the high bid depending on the bid chosen by firm j when $k_j > \theta$.
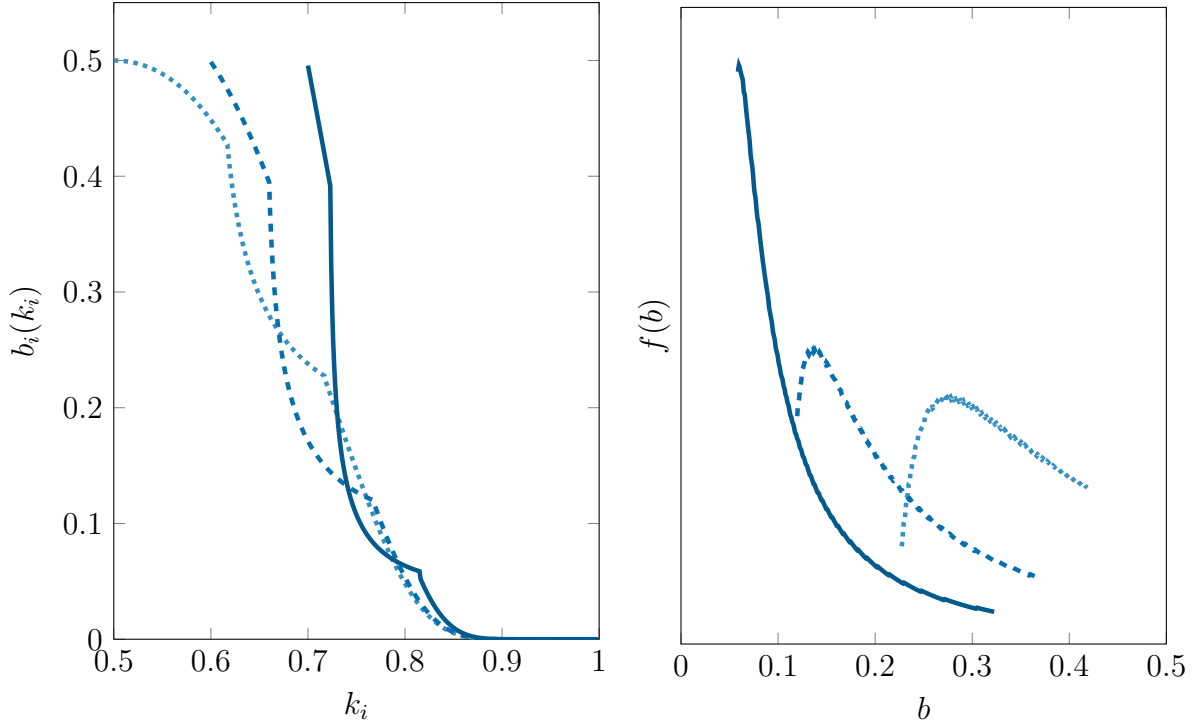
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Figure 7: Equilibrium bids and probability density when $k_i \sim U[0.5, 1.1]$ (dotted), $k_i \sim U[0.6, 1.2]$ (dashed) and $k_i \sim U[0.7, 1.3]$ (solid), with $\theta = 1$, $c = 0$, and $P = 0.5$.

Note: The figure shows the equilibrium price offers (left panel) and price distributions (right panel). As κ increases, the price offers move downwards, while the densities put more weight on lower prices.

As argued above, firm i's incentives to bid low are now stronger as compared to those in the withholding case, given that by reducing its price offer it can outbid the rival for a larger range of capacity realizations, including $k_j > \theta$. The equilibrium randomization, governed by the density function $f(b)$, is displayed in the rotated graph inside the figure.

Allowing $\overline{k}$ to increase above θ shows how the equilibrium bid schedules approach the competitive outcome. Suppose that capacities were uniformly distributed in $\left[\underline{k}, \overline{k}\right]$, and consider moving the whole capacity support to the right. For capacity realizations above θ, the equilibrium would put increasingly more weight on the lower bound of the price support, which converges towards c. In turn, the range $\left(\hat{k}, \tilde{k}\right)$ would widen up. This process would continue until $\underline{k}$ reached θ, in which case the equilibrium bid functions would become flat at marginal costs. Figure 7 provides an example depicting the process of convergence towards the competitive outcome.

We can now assess the effect on consumers of banning capacity withholding by comparing the equilibria characterized in Propositions 2 and 7. There are two forces operating in opposite directions. On the one hand, for $k_i > \theta$, capacity withholding yields lower bids
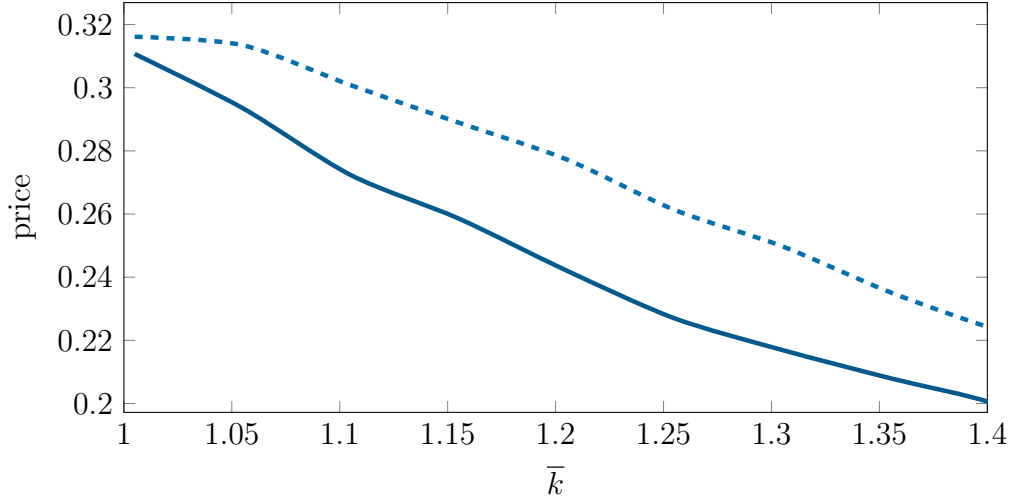
Figure 8: Equilibrium prices for $\underline{k} = 0.5$ and $\overline{k} > 1$ when withholding is possible (solid line) or not allowed (dashed line)

Note: This figure depicts the expected market price as a function of $\overline{k}$ under the assumptions $\theta = 1$, $c = 0$, and $P = 0.5$, and $k_i \sim U[\underline{k}, \overline{k}]$, for $\underline{k} = 0.5$ and $\overline{k} \in [1.05, 1.4]$. It shows that expected market prices are lower when capacity withholding is allowed.

as firms offer to produce θ at marginal cost. On the other hand, for $k_i \leq \theta$, firms' bids are weakly lower without capacity withholding, and strictly so for capacity realizations in the range $\left(\hat{k}, \tilde{k}\right)$. Numerical results like those illustrated in Figure 8 suggest that the first effect dominates. In particular, when capacities are uniformly distributed, banning capacity withholding gives rise to higher expected prices.

6 Concluding Remarks

In this paper we have analyzed equilibrium bidding in multi-unit auctions when bidders' production capacities are private information. We have allowed changes in capacity availability to shape the bidding functions, both through changes in the prices and the quantities offered by firms. This is unlike other papers in the literature, which typically assume that the private information is on costs (or bidders' valuations) and which, with few exceptions, do not allow bidders to act on both the price and quantity dimensions.

From a broad economic perspective, we have shown that the nature of private information and the strategies available to firms have a key impact on equilibrium behavior. As compared to cost shocks, equilibrium prices are more elastic to capacity shocks. The reason is two-fold: firms' price offers tend to be steeper in their private information, and firms find it optimal to offer more output at lower prices when they receive a positive

capacity shock. We have also shown that firms tend to exercise less market power the greater the capacity uncertainty. As a consequence, under private information on capacities, firms can obtain higher profits than when capacities are unknown, but less than when capacities are common knowledge.

Even though our model applies to a range of auction settings in which bidders possess private information about their capacities, our work was motivated in the context of electricity markets. Understanding competition among renewables is of first order importance to guide policy making in this area.

In this regard, our paper provides some key lessons about the future performance of electricity markets if their design remains as of today. First, our equilibrium characterization demonstrates that renewables will not in general make electricity markets immune to market power. Rather, firms will keep on exercising market power either by raising their bids or by withholding their output. The fact that the price offers are decreasing in firms' capacities implies that mark-ups will be lower at times of more available capacity, leading to price dispersion both within as well as across days, depending on weather conditions.

Renewables introduce a trade-off between price levels and price volatility. As we have shown, renewables tend to mitigate market power as compared to conventional technologies, as the former have unknown capacities while the capacities of the latter are known. However, to the extent that the marginal costs of fossil-fuels are less uncertain than the availability of renewables, market prices will also tend to be more volatile. The prevalence of positive mark-ups implies that the price-depressing effects of renewables will not be as pronounced as predicted under the assumption of perfect competition. Renewables will have a stronger price depressing effect in the long-run as installed renewable capacity goes up. The reduction in expected prices as a function of total investment will not be linear, but it will rather be smoother at the late stages of the energy transition.

Our model predicts that differences across renewable technologies (e.g. solar versus wind) will give rise to different market power impacts. For instance, solar will give rise to less market power than wind, to the extent that solar forecasts are typically less precise. Introducing correlation between demand and the expected availability of each technology would also highlight differences across technologies as, in contrast to solar power, wind would tend to depress prices when demand is low but would have little effect on prices

when demand is high. Competition among renewables could also be affected by portfolio effects, as firms typically own a variety of technologies whose joint distribution will affect firms' optimal bidding strategies. In sum, future electricity markets would depict large price differences across the day and across the year, reflecting differences in weather conditions and the associated differences in firms' ability to charge positive mark-ups.

The aim of this paper has not been to identify the optimal design of future electricity markets, but rather to analyze their future performance if the current mechanisms remain unchanged. It has shown that deploying renewables without further market design changes will not be enough to achieve efficient outcomes. Regulators will have to rely on other instruments or other market designs if they aim at fully eliminating market power.

Notably, our analysis has taken capacities as given and has omitted storage. An issue that deserves further research is whether the current mechanisms will induce the desired investments both in renewables as well as in storage facilities. This paper has provided a first step in this highly policy relevant research agenda.

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A   Proofs

Proof of Lemma 1: For part (i) of the lemma, suppose that firm j chooses a bid according to a distribution $F_j(b_j, q_j|k_j)$. Profits for firm i can be written as

$$\pi_i(b_i, q_i, F_j|k_i) = \int_{(b,q \geq \underline{k})} [(b-c)q_i \Pr(b_i \leq b) \\ + (b_i - c)(\theta - q) \Pr(b_i > b)] \, dF_j(b, q|k_j)g(k_j)dk_j.$$

The above equation is increasing in q_i, indicating that the firm maximizes profits by choosing $q_i^*(k_i) = k_i$. In what follows we simplify the notation by eliminating q_i from the profit function π_i and by indicating that the randomization is only over prices, $F_i(b_i|k_i)$.

For part (ii), consider, towards a contradiction, two bids b_i and $b_i' > b_i$ for which firm i randomizes. Then, it must be that firm i is indifferent between both and, thus,

$$\pi_i(b_i', F_j|k_i) - \pi_i(b_i, F_j|k_i) = \int_{\underline{k}}^{\overline{k}} \int_b \{(b-c)k_i \left[\Pr(b_i' \leq b) - \Pr(b_i \leq b)\right] \tag{4}$$
$$+(\theta - k_j)\left[(b_i' - c)\Pr(b_i' > b) - (b_i - c)\Pr(b_i > b)\right]\} \, dF_j(b|k_j)g(k_j)dk_j = 0.$$

Since j cannot condition the strategy on k_i, then $F_j(b_j|k_j)$ must be such that the previous expression holds for all k_i. Hence, either $b_j(k_j) = c$ for all k_j, in which case $F_j(b_j|k_j)$ would be a degenerate mixed-strategy, or

$$\int_{k_j} \int_b [\Pr(b_i' \leq b) - \Pr(b_i \leq b)] \, dF_j(b|k_j)g(k_j)dk_j = 0.$$

By Bertrand arguments, F_j cannot contain gaps in the support and, therefore, this cannot occur. Given that the second part of equation (4) does not depend on k_i this leads to a contradiction.

Regarding part (iii) of the lemma, using the previous result we can focus on firm j choosing a pure-strategy. As a result, it is enough to show that the function $\pi_i(b_i, b_j|k_i)$ has non-increasing differences in b_i and k_j. Using the previous expression and taking the derivative with respect to k_i we have

$$\frac{\partial \left[\pi_i(b_i', b_j|k_i) - \pi_i(b_i, b_j|k_i)\right]}{\partial k_i} =$$
$$\int_{\underline{k}}^{\overline{k}} (b_j(k_j) - c)k_i \left[\Pr(b_i' < b_j(k_j)) - \Pr(b_i < b_j(k_j))\right] g(k_j)dk_j \leq 0.$$

In words, larger firms gain (weakly) less from increasing their bids. Hence, the optimal bid function is non-increasing in k_i. $\qquad \square$

Proof of Proposition 1: See Fabra et al. (2006).

Proof of Proposition 2: Expected profits can be written as

$$\pi_i\left(b_i, b_j | k_i\right) = \int_{\underline{k}}^{b_j^{-1}(b_i)} (b_j(k_j) - c) k_i g(k_j) dk_j$$

$$+ \int_{b_j^{-1}(b_i)}^{\overline{k}} (b_i - c)(\theta - k_j) g(k_j) dk_j, \tag{5}$$

and the first-order condition that characterizes the optimal bid of firm i can be written as

$$\frac{\partial \pi_i}{\partial b_i} = b_j^{-1\prime}(b_i) g(b_j^{-1}(b_i))(b_i - c)(k_i + b_j^{-1}(b_i) - \theta) + \int_{b_j^{-1}(b_i)}^{\overline{k}} (\theta - k_j) g(k_j) dk_j = 0. \tag{6}$$

Under symmetry, $b_j(k) = b_i(k)$. Accordingly, we can rewrite the expression as

$$\frac{1}{b_i'(k_i)} g(k_i)(b_i(k_i) - c)(2k_i - \theta) + \int_{k_i}^{\overline{k}} (\theta - k_j) g(k_j) dk_j = 0. \tag{7}$$

The first term of the first order condition (7) is negative and the second term is positive, taking the form

$$b_i'(k_i) + a(k_i) b_i(k_i) = ca(k_i),$$

where

$$a(k) = \frac{(2k - \theta) g(k)}{\int_k^{\overline{k}} (\theta - k_j) g(k_j) dk_j}. \tag{8}$$

If we multiply both sides by $e^{\int_{\underline{k}}^{k} a(s)ds}$ and integrate from $\underline{k}$ to k_i we obtain

$$\int_{\underline{k}}^{k_i} \left(e^{\int_{\underline{k}}^{k} a(s)ds} b_i'(k) + a(k) e^{\int_{\underline{k}}^{k} a(s)ds} b_i(k) \right) dk_i = c \int_{\underline{k}}^{k_i} a(k_i) e^{\int_{\underline{k}}^{k} a(s)ds} dk_i.$$

We can now evaluate the integral as

$$\left. e^{\int_{\underline{k}}^{k} a(k)dk} b_i(k) \right]_{\underline{k}}^{k_i} = \left. c e^{\int_{\underline{k}}^{k} a(s)ds} \right]_{\underline{k}}^{k_i}.$$

This results in

$$e^{\int_{\underline{k}}^{k_i} a(k)dk} b_i(k_i) - b_i(\underline{k}) = c e^{\int_{\underline{k}}^{k_i} a(k)dk} - c.$$

Solving for $b_i(k_i)$ we obtain

$$b_i(k_i) = c + A e^{-\int_{\underline{k}}^{k_i} a(k)dk} = c + A e^{-\omega(k_i)},$$

where $A \equiv b_i(\underline{k}) - c$ and $\omega(k_i) \equiv \int_{\underline{k}}^{k_i} a(k)dk$.

A necessary condition for an equilibrium is that the resulting profits are at or above the minimax, which the firm can obtain by bidding at P. Hence, a necessary condition for equilibrium existence is that

$$\pi_i\left(b_i, b_j | k_i\right) \geq \int_{\underline{k}}^{\overline{k}} (P - c)(\theta - k_j) g(k_j) dk_j. \tag{9}$$

Hence, to rule out deviations to P, we now need to prove that minimax profits increase less in k_i as compared to equilibrium profits. The derivative of the minimax is

$$(P - c)\left(G\left(\theta - k_i\right) - g\left(\theta - k_i\right) k_i\right).$$

The derivative of profits is

$$\int_{\underline{k}}^{b_j^{-1}(b_i)} (b_j(k_j) - c) k_i g(k_j) dk_j.$$

This derivative is greater than that of the minimax.

It follows that deviations to P are not profitable since equilibrium profits are always strictly greater than the minimax, except for $k_i = \underline{k}$ when equilibrium profits are exactly equal to the minimax.

Finally, we need to verify that the candidate equilibrium, indeed, maximizes profits for each of the firms. From the first order condition in (6) we can compute the second derivative of the profit function of firm i, when firm j uses a bidding function $b_j(k_j)$ as

$$\frac{g(b_j^{-1}(b_i))}{b_j'(k_j)} \left(-\frac{b_j''(k_j)}{\left(b_j'(k_j)\right)^2} (b_i - c)(k_i + b_j^{-1}(b_i) - \theta) + \frac{1}{b_j'(k_j)} \frac{g'(b_j^{-1}(b_i))}{g(b_j^{-1}(b_i))} (b_i - c)(k_i + b_j^{-1}(b_i) - \theta) \right.$$
$$\left. + (k_i + b_j^{-1}(b_i) - \theta) + \frac{1}{b_j'(k_j)} (b_i - c) - (\theta - b_j^{-1}(b_i)) \right).$$

Once we substitute the candidate equilibrium $b_i(k) = b_j(k)$ the previous expression becomes

$$\frac{\partial^2 \pi_i}{\partial^2 b_i(k_i)} = \frac{g(k_i)}{b^{*\prime}(k_i)} \frac{1}{a(k_i)} < 0.$$

Because there is a unique solution to the first order condition, this implies that the profit function is quasiconcave and guarantees the existence of the equilibrium. In particular, this rules out deviations where firms choose any lower bid, including c. □

Proof of Proposition 3: We first show that, for $k_i \geq \theta$ and any price offer b_i, quantity $q_i > \theta$ is dominated by offering $q_i = \theta$. If the firm offers $q_i = \theta$, its expected profits are

$$\pi_i(b_i, b_j(k_j) | q_i = \theta) = \int_{\underline{k}}^{b_j^{-1}(b_i)} (b_j(k_j) - c)\theta g(k_j) dk_j + \int_{b_j^{-1}(b_i)}^{\overline{k}} (b_i - c)(\theta - k_j) g(k_j) dk_j. \tag{10}$$

Instead, if the firm offers $q_i > \theta$, its expected profits are

$$\pi_i(b_i, b_j(k_j)|q_i > \theta) = \int_{\underline{k}}^{b_j^{-1}(b_i)} (b_i - c)\theta g(k_j)dk_j + \int_{b_j^{-1}(b_i)}^{\overline{k}} (b_i - c)(\theta - k_j)g(k_j)dk_j.$$

The inspection of the above equation in comparison with (10), shows that offering $q_i > \theta$ is dominated by $q_i = \theta$: the second term is the same as in equation (10), while the first term is now smaller since, over this range, $b_j(k_j) > b_i$. Given the optimality of $q_i = \theta$, the problem is the same as the one solved in Propositions 1 and 2, with $G(k_i)$ now adjusted to $G(q_i^*(k_i))$, $i = 1, 2$.

Proof of Lemma 2: It follows from Proposition 1 and 3. However, unlike in those cases, the fact that capacities are random and observable provides a randomization device which allows firms to symmetrize the equilibrium through perfect correlation between the two asymmetric pure-strategy equilibria.

For the characterization of the mixed-strategy equilibrium see Fabra et al. (2006). The only difference is that here we allow for capacity withholding. However, note that this does not affect the expected equilibrium profits as these depend on the residual demand of the high bidder, which the firm can always satisfy. □

Proof of Lemma 3: The proof is analogous as in the case in which demand is unknown and capacities are symmetric and known. See Fabra et al. (2006) for the analysis without withholding.

If withholding is allowed, firms choose q_i after the bids have been placed. If realized capacities are below θ firm profits are weakly increasing in k_i. Therefore they never find optimal to withhold. If, instead, firms have realized capacities above θ, for the same reason as in the benchmark model, they find optimal to only offer to produce $q_i = \theta$. In the first stage, when firms choose prices, they behave as if their capacity had a mass point at θ. See Proposition 3.

In either case, expected profits are given by the minimax, as a firm choosing a bid P will always serve the residual demand, which $\theta - E(k|k \leq \theta)$. □

Proof of Proposition 4: It follows from the proofs of Lemmas 2 and 3. □

Proof of Proposition 5: We show that there is no profitable deviation from the candidate equilibrium stated in the text of the proposition.

Regarding part (i), the same logic as in Proposition 1 applies.

For part (ii), let's start by focusing on $k_i \in [\underline{k}_1, \overline{k}_2]$. It is easy to see that a counterpart of Lemma 1 applies in this case. As a result, the profit function of both firms can be written as

$$\pi_i(b_i, b_j(k_j)) = (P - c)k_i G_i(\underline{k}_1) + \int_{\underline{k}_1}^{b_j^{-1}(b_i)} (b_j(k_j) - c)k_i g_j(k_j)dk_j$$
$$+ \int_{b_j^{-1}(b_i)}^{\overline{k}_2} (b_i - c)(\theta - k_j)g_j(k_j)dk_j.$$

Under the assumption that $g_i(k_i)$ is uniformly distributed in an interval of the same length, we have $g_i(k_i) = g_j(k_j)$ for $k_i \in [\underline{k}_i, \overline{k}_i]$ and $i = 1, 2$. As a result, the profit function of the two firms is identical because the bid function in this range is the same. Hence, the first condition is also the same and it coincides with equation (7) in the proof of Proposition 1, leading to expression (3).

It remains to show that (1) $b_2(k_2) = P$ for $k_2 < \underline{k}_1$ and (2) $b_1(k_1) = c$ when $k_1 > \overline{k}_2$. Regarding (1), by definition of equilibrium we have that $\pi_2(\underline{k}_1, P) \geq \pi_2(\underline{k}_1, b)$ for $b < P$. Since firm 2 can always satisfy the residual demand, we also have that for $k_2 < \underline{k}_1$, the firm makes the same level of profits, $\pi_2(\underline{k}_1, P) = \pi_2(k_2, P)$. In turn, since profits are always increasing in capacity, we also have that for any $b < P$, $\pi_2(\underline{k}_1, b) > \pi_2(k_2, b)$. This shows that (1) is optimal.

With respect to (2), by definition of equilibrium we have that $\pi_1(\overline{k}_2, c) \geq \pi_1(\overline{k}_2, b)$ for any $b > c$. Furthermore, for all $k_1 \geq \overline{k}_2$, profits increase faster with capacity when the firm bids at c than when it bid at any $b > c$, $\frac{\partial \pi_1}{\partial k_1}(k_1, c) > \frac{\partial \pi_1}{\partial k_1}(k_1, b)$. This shows that (2) is optimal. $\qquad \square$

Proof of Proposition 6: Profits for firm i are:

$$\pi_i(b_i, b_j | k_i) = \int_{\underline{k}}^{b_j^{-1}(b_i)} (b_j(k_j) - c)k_i \varphi(k_j)dk_j$$
$$+ \int_{b_j^{-1}(b_i)}^{\overline{k}} (b_i - c)\left(\theta - k_j - \int_{k_j}^{\overline{k}} (N-2)\, kg(k)dk\right) \varphi(k_j)dk_j$$

The first-order condition that characterizes the optimal bid of firm i can be written as

$$\frac{\partial \pi_i}{\partial b_i(k_i)} = b_j^{-1\prime}(b_i)\varphi(b_j^{-1}(b_i))(b_i - c)\left(k_j + \int_{k_j}^{\overline{k}} (N-2)\, kg(k)dk + b_j^{-1}(b_i) - \theta\right)$$
$$+ \int_{b_j^{-1}(b_i)}^{\overline{k}} \left(\theta - k_j - \int_{k_j}^{\overline{k}} (N-2)\, kg(k)dk\right) \varphi(k_j)dk_j = 0.$$

Under symmetry, $b_j(k) = b_i(k)$, we can rewrite the expression as

$$\frac{\partial \pi_i}{\partial b_i(k_i)} = \frac{1}{b_i'(k_i)}\varphi(k_i)(b_i(k_i) - c)\left(2k_i + \int_{k_i}^{\bar{k}}(N-2)\,kg(k)dk - \theta\right)$$

$$+ \int_{k_i}^{\bar{k}}\left(\theta - k_j - \int_{k_j}^{\bar{k}}(N-2)\,kg(k)dk\right)\varphi(k_j)dk_j = 0$$

Reorganizing it,

$$b_i'(k_i) + b_i(k_i)a(k_i) = ca(k_i)$$

where $a(k_i)$ does not depend on b_i,

$$a(k_i) = \frac{\left(2k_i + \int_{k_i}^{\bar{k}}(N-2)\,kg(k)dk - \theta\right)\varphi(k_i)}{\int_{k_i}^{\bar{k}}\left(\theta - k_j - \int_{k_j}^{\bar{k}}(N-2)\,kg(k)dk\right)\varphi(k_j)dk_j}.$$

Hence, the solution is the same as above:

$$b_i^*(k_i) = c + (P - c)\,e^{-\omega(k_i)}$$

where $\omega(k_i) \equiv \int_{\underline{k}}^{k_i} a(k)dk$. $\qquad\qquad\qquad\qquad\qquad\qquad\qquad\square$

Proof of Proposition 7: A symmetric Bayesian Nash Equilibrium must have the following properties. First, using the same arguments in Proposition 2, the optimal bid must be strictly decreasing in k_i for $k_i < \theta$. Second, for $k_i \geq \theta$ profits do not depend on k_i. To see this, note that the expected profits for firm i given b_i are as follows. If $b_i > b_j(\theta)$, then

$$\pi_i(b_i, b_j(k_j)|k_i) = (b_i - c)\left(\int_{\underline{k}}^{b_j^{-1}(b_i)}\theta g(k_j)dk_j + \int_{b_j^{-1}(b_i)}^{\theta}(\theta - k_j)g(k_j)dk_j\right).$$

Instead, if $b_i \leq b_j(\theta)$,

$$\pi_i(b_i, b_j(k_j)|k_i) = (b_i - c)\int_{\underline{k}}^{b_j^{-1}(b_i)}\theta g(k_j)dk_j.$$

As a result all bids that are chosen in equilibrium for any $k_i \geq \theta$ must yield the same profits for the firm.

Without loss of generality assume that when $k_i \geq \theta$ firm i bids b with density $f_i(b)$ and distribution $F_i(b)$, in the support $[\underline{b}, \bar{b}]$ with $\bar{b} \leq b(\underline{k})$ and $\underline{b} \geq b(\theta)$. At the end of the proof we characterize am equilibrium bidding function $b_i(k_i)$ that generates this distribution of bids. We define $\tilde{k} = b_j^{-1}(\bar{b})$ and $\hat{k} = b_j^{-1}(\underline{b})$. Since $b_j(k_j)$ is decreasing, it follows that $\left[\tilde{k}, \hat{k}\right] \subseteq [\underline{k}, \theta]$. We consider four capacity regions:

Region I. If $k_i \in \left[\underline{k}, \tilde{k}\right]$, expected profits are

$$\pi_i(b_i, b_j(k_j)|k_i) = \int_{\underline{k}}^{b_j^{-1}(b_i)} (b_j(k_j) - c)k_i g(k_j)dk_j + \int_{b_j^{-1}(b_i)}^{\theta} (b_i - c)(\theta - k_j)g(k_j)dk_j$$

Firm i has the low bid when $k_j < b_j^{-1}(b_i)$ and, hence sells up to capacity at the price set by firm j. Otherwise, either it sells the residual demand and sets the price or, if $k_j > \theta$ the rival will serve all the market.

Taking derivatives, we obtain a similar First Order Condition as in equation (7), with the only difference that $\overline{k}$ is replaced by θ. Hence, the solution is the same as in Proposition 2, with the only difference that $\overline{k}$ is replaced by θ in equation (8). Hence, the optimal bid in this region is

$$b^*(k_i) = c + (P - c) e^{-\omega(k_i)}, \tag{11}$$

where $\omega(k_i) \equiv \int_{\underline{k}}^{k_i} a(k)dk$, and

$$a(k) = \frac{(2k - \theta)g(k)}{\int_k^{\theta} (\theta - k_j)g(k_j)dk_j}. \tag{12}$$

Using the optimal bid in (11), for given $\overline{b}$, $\tilde{k}$ is implicitly defined by

$$b^*\left(\tilde{k}\right) = \overline{b}.$$

Region II. If $k_i \in \left[\tilde{k}, \hat{k}\right]$, expected profits are

$$\pi_i(b_i, b_j(k_j)|k_i) = \int_{\underline{k}}^{b_j^{-1}(b_i)} (b_j(k_j) - c)k_i g(k_j)dk_j + \int_{b_j^{-1}(b_i)}^{\theta} (b_i - c)(\theta - k_j)g(k_j)dk_j$$

$$+ (1 - G(\theta)) \int_{b_i}^{\overline{b}} (b_j - c)k_i f_j(b_j) db_j.$$

The profit expression now adds a third term as the firm will serve all its capacity at the price set by the rival whenever $k_j \geq \theta$ and $b_i < b_j$.

The first-order condition that characterizes the optimal bid of firm i can be written as

$$\frac{1}{b_j'(k_j)}g(b_j^{-1}(b_i))(b_i - c)(k_i + b_j^{-1}(b_i) - \theta) + \int_{b_j^{-1}(b_i)}^{\theta} (\theta - k_j)g(k_j)dk_j - (1 - G(\theta))(b_i - c)k_i f_j(b_i) = 0.$$

This expression is similar to equation (7), where $\bar{k}$ replaces θ, plus an additional third term, which is negative. If follows that the optimal bid that solves the above equation is lower than the optimal bid in the baseline case.

Using symmetry, the optimal bid is the solution to

$$\left(1 - \frac{(1-G(\theta))(b(k)-c)kf(b(k))}{(2k-\theta)g(k)}a(k)\right)b'(k) + a(k)b(k) = ca(k),$$

where $a(k)$ is defined as in equation (12). Note that if $G(\theta) = 1$ we would obtain the same solution as in the baseline case. Since we now have $G(\theta) < 1$, the solution is lower.

Region III. If $k_i \in \left[\hat{k}, \theta\right]$, expected profits are

$$\pi_i(b_i, b_j(k_j)|k_i) = \int_{\underline{k}}^{b_j^{-1}(b_i)} (b_j(k_j)-c)k_i g(k_j)dk_j + \int_{b_j^{-1}(b_i)}^{\theta} (b_i - c)(\theta - k_j)g(k_j)dk_j$$

$$+ (1 - G(\theta))\int_{\underline{b}}^{\bar{b}} (b_j - c)k_i f_j(b_j)\, db_j.$$

The first-order condition that characterizes the optimal bid of firm i is the same as in Region I as the last term does not depend on b_i. Hence, the solution is also given by expressions (11) and (12). Hence, (11), for given $\underline{b}$, $\hat{k}$ is implicitly defined by $b^*(\hat{k}, \underline{k}, \theta) = \underline{b}$.

Region IV. Last, consider $k_i \in \left[\theta, \bar{k}\right]$. Expected profits are given by,

$$\pi_i(b_i, b_j(k_j)|k_i) = (b_i - c)\left(\int_{\underline{k}}^{b_j^{-1}(b_i)} \theta g(k_j)dk_j \right.$$

$$\left. + \int_{b_j^{-1}(b_i)}^{\theta} (\theta - k_j)g(k_j)dk_j + (1 - F_j(b_i))(1 - G(\theta))\theta \right) \quad (13)$$

We now characterize the equilibrium distribution $F_j(b)$. At the upper bound of the support, $F_j(\bar{b}) = 1$. Hence, $\bar{b}$ maximizes

$$\pi_i(\bar{b}, b_j|k_i) = (\bar{b} - c)\left(\int_{\underline{k}}^{b_j^{-1}(\bar{b})} \theta g(k_j)dk_j + \int_{b_j^{-1}(\bar{b})}^{\theta} (\theta - k_j)g(k_j)dk_j\right)$$

$$= (b^*(\tilde{k}) - c)\left(\theta G(\theta) - \int_{\tilde{k}}^{\theta} k_j g(k_j)dk_j\right)$$

Taking derivatives with respect to $\bar{b}$,

$$\theta G(\theta) - \int_{b_j^{-1}(\bar{b})}^{\theta} k_j g(k_j)dk_j + (\bar{b} - c)\frac{1}{b_j'(k_j)}g(b_j^{-1}(\bar{b}))b_j^{-1}(\bar{b}) = 0$$

Using the definition of $\tilde{k}$ above, it can be re-written as

$$\theta G(\theta) - \int_{\tilde{k}}^{\theta} k_j g(k_j)dk_j + (\bar{b} - c)\frac{1}{b_j^{*\prime}(\tilde{k})}g(\tilde{k})\tilde{k} = 0.$$

From the analysis of the case with small installed capacities we know that

$$b_i'(k_i) + a(k_i)b_i(k_i) = ca(k_i)$$

so that

$$b_j'(k_j) = - \left(b_i(k_i) - c \right) a(k_i)$$

Hence,

$$\theta G(\theta) - \int_{\tilde{k}}^{\theta} k_j g(k_j)dk_j - (\bar{b} - c)\frac{1}{\left(b^*(\tilde{k}) - c \right) a(\tilde{k})} g(\tilde{k})\tilde{k}$$

Since $b^*(\tilde{k}) = \bar{b}$,

$$\theta G(\theta) - \int_{\tilde{k}}^{\theta} k_j g(k_j)dk_j - \frac{g(\tilde{k})\tilde{k}}{a(\tilde{k})} = 0$$

Using the expression for $a(k)$ in equation (12),

$$\theta G\left(\tilde{k}\right) - \frac{\theta - \tilde{k}}{2\tilde{k} - \theta} \int_{\tilde{k}}^{\theta} (\theta - k_j) g(k_j)dk_j = 0,$$

which defines $\tilde{k}$. Note that we must have an interior solution, $\tilde{k} \in (\underline{k}, \theta)$. For $\tilde{k} = \underline{k}$, the first term is zero so the left hand side would be negative; whereas for $\tilde{k} = \theta$, the second term is zero so the left hand side would be positive.

At the lower bound of the support, $F_j(\underline{b}) = 1$. Expected profits are

$$\begin{aligned}\pi_i(\underline{b}, b_k|k_i) &= (\underline{b} - c)\left(\theta - \int_{b_j^{-1}(\underline{b})}^{\theta} k_j g(k_j)dk_j \right) \\ &= (b(\hat{k}) - c)\left(\theta - \int_{\hat{k}}^{\theta} k_j g(k_j)dk_j \right)\end{aligned}$$

Since the firm must be indifferent between all the prices in the support, profits at the lower and upper bounds must be equal,

$$(\bar{b} - c)\left(\theta G(\theta) - \int_{b_j^{-1}(\bar{b})}^{\theta} k_j g(k_j)dk_j \right) = (\underline{b} - c)\left(\theta - \int_{b_j^{-1}(\underline{b})}^{\theta} k_j g(k_j)dk_j \right) = \pi^*$$

Using the definitions for $\bar{b}$ and $\underline{b}$,

$$(b^*(\tilde{k}) - c)\left(\theta G(\theta) - \int_{\tilde{k}}^{\theta} k_j g(k_j)dk_j \right) = (b^*(\hat{k}) - c)\left(\theta - \int_{\hat{k}}^{\theta} k_j g(k_j)dk_j \right) = \pi^*$$

which defines $\hat{k}$. Hence, equilibrium profits are well defined $\underline{\pi}$ and we can treat them like a constant.

By the above equality, when $\bar{k}$ is just above θ, $\tilde{k}$ is arbitrarily close to $\hat{k}$. Instead, when $\underline{k}$ is so large that $G(\theta) = 0$, then $b(\hat{k}) = c$.

Now, we can use the above expression for equilibrium profits to solve for $F(b)$ in equation (13),

$$F(b) = \frac{1}{(1 - G(\theta))\theta} \left(\theta - \int_{b^{*-1}(b)}^{\theta} kg(k)dk - \frac{\pi^*}{(b-c)} \right)$$

where $b^*(k)$ is defined above by expressions (11) and (12).

Computing the density,

$$f(b) = \frac{1}{(1 - G(\theta))\theta} \left(\frac{\pi^*}{(b-c)^2} + \frac{k}{b^{*\prime}(k)} g(k) \right).$$

Since $G(k)$ and $F(b)$ are continuous and strictly increasing, we can construct an equilibrium bidding function in pure-strategies that reproduces this distribution if bids as $b(k) \equiv F^{-1}\left(\frac{G(k) - G(\theta)}{1 - G(\theta)} \right)$. $\square$