



## Setting a methodology for the NZ Emissions Trading Scheme auction confidential reserve price

Date Submitted:	16 February 2021	Tracking #: 2021-B-07514	
Security Level	IN CONFIDENCE	MfE Priority:	Non-Urgent

	Action sought:	Response by:
To Hon James Shaw, Minister of Climate Change	Agree to the recommended methodology Forward to Minister of Finance	22 February 2021

Actions for Minister's Office Staff	<b>Forward</b> this report to the Minister of Finance <b>Return</b> the signed report to MfE.
Number of appendices and attachments 1	Titles of appendices and attachments (ie separate attached documents): 1. Overview - NZ Emissions Trading Scheme auctions and the operation of the confidential reserve price

### Ministry for the Environment contacts

Position	Name	Cell phone	1 <sup>st</sup> contact
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## Setting a methodology for the NZ Emissions Trading Scheme auction confidential reserve price

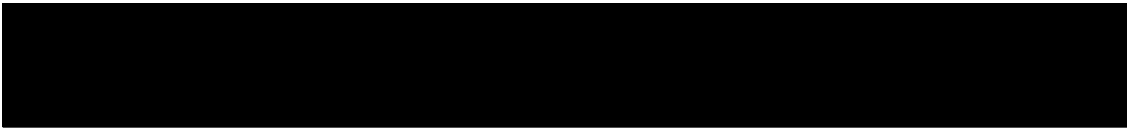

### Key Messages

1. The purpose of this briefing is to advise you on a recommended methodology to set a confidential reserve price for New Zealand Emissions Trading Scheme (NZ ETS) auctions in consultation with the Minister of Finance.
2. This briefing further advises what you are required to do to enable the first methodology for a confidential reserve price to be set in time for the first auction on 17 March 2021 under the Climate Change Response (Auction Price) Amendment Bill (the Bill).

### Setting a Confidential Reserve Price

3. The purpose of the confidential reserve price is to ensure units sold at auction cannot be sold significantly below the prevailing secondary market price and thereby avoid unduly negatively influencing the secondary market.
4. The Bill, which is currently before Select Committee, amends the Act to enable regulations to be set to provide for a confidential reserve price and also directly amends the Climate Change (Auctions, Limits, and Price Controls for Units) Regulations 2020 (the Regulations) for this purpose. The Bill needs to be passed and enacted by 15 March to ensure a confidential reserve price can be in place for the first auction on 17 March.
5. If the Bill passes as introduced, you would be required to set a confidential methodology that the auction operator (NZX Limited) would apply to calculate the confidential reserve price. The Bill sets out certain criteria that you must consider when setting the methodology.
6. In order for the confidential reserve price to apply to the first auction, the Chief Executive of the Ministry for the Environment<sup>1</sup> would need to supply that methodology to NZX Limited no later than 15 March 2021, ideally earlier. This means that you would need to issue your decision on the methodology before the Bill is enacted. There are transitional provisions in the Bill that allow an early decision on the methodology to be treated as if it were made after enactment.

### Recommended methodology

- s9(2)(ba) 7. 
- s9(2)(ba) 8.  any related definitions or explanations as outlined in this briefing are required to be kept confidential to avoid becoming the target of bidding strategies at auction.

### Meeting the requirements of the Bill to set a confidential reserve price

9. This briefing includes advice on how you can consider the criteria outlined in the Bill that must be considered when setting the methodology. In the Bill as introduced, you are required to consider:
  - 9.1. the need for the methodology to include:

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<sup>1</sup> The Secretary for the Environment.

- 9.1.1. a way to determine a representative price for New Zealand units sold on secondary markets recently before the auction, taking into account any volatility in prices (Supporting material, paragraphs 16-19)
  - 9.1.2. a way to determine a price below the representative price that will achieve the purpose of the confidential reserve price (Supporting material, paragraphs 22-25)
  - 9.2. the purpose of confidential reserve prices (Supporting material, paragraphs 26-31)
  - 9.3. the main matters and additional matters in section 30GC(5) and (6) of the Act (Supporting material, Table 1: Considering the main and additional matters under section 30GC of the Act).
10. The Bill also requires you to consult with the Minister of Finance when setting the methodology.

#### *Risks*

11. We have prepared this briefing in accordance with the criteria in the Bill as introduced. However, if these criteria change prior to the Bill being enacted, you will likely need to repeat the consideration using the new criteria and this may lead to a different methodology. This creates the potential for a timing risk in order for the confidential reserve price to be in place in time for the new auction. If the criteria are changed by Parliament, we will prepare an urgent briefing for you to reconsider the methodology according to the amended criteria. You would also need to urgently consult with the Minister of Finance on the new methodology.
12. There are also risks in how you set the methodology. The methodology needs to set the confidential reserve price at a level that balances:
- 12.1. the risk that auctions clear 'significantly below' the secondary market price (ie if the confidential reserve price was set too low) which would be disruptive to the market and create fiscal risks; against
  - 12.2. the risk that the confidential reserve price prevents units being sold at that auction (ie that the confidential reserve price was set too high), which has flow on impacts for NZ ETS participants' access to units.

#### *Next steps –consultation with the Minister of Finance*

13. As you are required to consult with the Minister of Finance when setting this methodology, we recommend you forward this briefing to his office and consider any feedback he provides before making your decision.
14. We recommend that you ask for feedback from the Minister of Finance by 5 March to ensure the methodology can be agreed and confirmed to the auction operator at least ten days before the first auction date of 17 March 2021.
15. The recommended methodology has been discussed with Treasury officials who have not raised any concerns. We have also sent them a copy of this briefing.
16. Please advise us if you would like to discuss this briefing at the officials meeting on 22 February.

## Recommendations

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We recommend that you:

- a. **Note** that, if the Bill passes as introduced, you will be required to set a methodology for a confidential reserve price, in consultation with the Minister of Finance.
- b. **Note** that in order for a confidential reserve price to be in place for the first NZ ETS auction on 17 March 2021, the Chief Executive for the Ministry for the Environment will need to provide the methodology to the auction operator by 15 March 2021.
- c. **Note** the methodology can be set now under the transitional arrangements of the Climate Change Response (Auction Price) Amendment Bill (the Bill) after consideration of specified criteria.
- d. **Note** our advice for considering the following criteria when setting the methodology. You must consider:
  1. the need for the methodology to include:
    - 1.1. a way to determine a representative price for New Zealand units (Supporting material, paragraphs 16-21)
    - 1.2. a way to determine a price below the representative price that will achieve the purpose of the confidential reserve price (Supporting material, paragraphs 22-25)
  2. the purpose of confidential reserve prices (Supporting material, paragraphs 26-31)
  3. the main matters and additional matters in section 30GC(5) and (6) of the Act (Supporting material, Table 1).
- e. **Note** that the methodology needs to set the confidential reserve price at a level that balances the risk that auctions clear 'significantly below' the secondary market price against the risk that the confidential reserve price prevents units being sold at that auction, which has flow on impacts for NZ ETS participants access to units
- f. **Meet** with officials at the weekly meeting on 22 February for further discussion if required

Yes/No

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g.

h.

- i. **Agree** to forward this briefing to the Minister of Finance and consider any feedback he provides before making your decision

Yes/No

- j. Agree that this briefing and appendices will be released proactively on the Ministry for the Environment's website within the next eight weeks.

Yes/No

**Signature**

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Electronically approved by Matthew Cowie

Matthew Cowie  
Principal Analyst – Climate Policy  
**Ministry for the Environment**

**Date**



Hon James Shaw  
**Minister of Climate Change**

21/2/24  
**Date**

## Supporting material

### Purpose

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1. This briefing provides a recommended methodology to use to set a confidential reserve price for NZ ETS auctions. The purpose of the confidential reserve price is to ensure units sold at auction cannot be sold significantly below the prevailing secondary market price and thereby avoid unduly influencing the secondary market.
2. This briefing also advises on the steps needed under the transitional arrangements of the Climate Change Response (Auction Price) Amendment Bill to enable this to be set in time for the first auction on 17 March. Due to timing considerations, we are preparing this advice based on legal tests in the Bill that may change during the Select Committee process.

### Context

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*A confidential reserve price is needed for auctions under the Emissions Trading Scheme reforms*

3. The Climate Change Response Act 2002 (the Act) was amended in June 2020 to ensure the Government has the tools needed to manage the supply of units into the NZ ETS market, by setting clear caps on emissions in line with our climate change targets and developing a robust auctioning system.
4. The Act provides an overall framework for auctioning in the NZ ETS, while regulations set specific details to give effect to the framework. Regulations cover setting the rules for auctioning, price control values and the number of units available to sell at auction.
5. In September 2020, regulations setting the rules for auctioning in the NZ ETS were set without a confidential reserve price (known then as a technical reserve price) due to an issue with the Act, despite a previous Cabinet decision to set one [DEV-20-MIN-0047 refers].
6. A key objective for auctioning in the NZ ETS is to improve regulatory certainty and predictability while implementing an efficient auction system that supports market efficiency. Design decisions on the rules for auctioning, including decisions regarding the confidential reserve price, have therefore taken into account the need to avoid disrupting the secondary market.

*The Auction Price Amendment Bill is intended to enable a confidential reserve price to be set before the first auction on 17 March 2021*

7. Following public commentary on the omission of a confidential reserve price, further analysis advised that a confidential reserve price is needed to avoid risk to NZ ETS auctions. Cabinet decided in December 2020 to amend the Act and related regulations to enable a confidential reserve price for NZ ETS auctions before the first auction on 17 March 2021 [DEV-20-MIN-0173 refers].
8. In January 2021 Cabinet approved the introduction of the Climate Change Response (Auction Price) Amendment Bill (the Bill) [CBC-21-MIN-0011 refers]. The Bill was introduced to Parliament on 5 February 2021 and is currently being considered by the Environment Select Committee under a shortened timeline to allow the Bill to be enacted by 15 March in time for the first auction two days later.

*The Auction Price Bill modifies both the Act and Regulations to enable the Minister to set a methodology after consideration of certain criteria*

9. The Bill amends the Act to state that the Minister of Climate Change (the Minister) may recommend making regulations to set a methodology for the confidential reserve price below which New Zealand units must not be sold at auction, providing that the resulting price is less than or equal to the lowest cost containment reserve trigger price. The methodology outlined in Appendix 1 meets this requirement.
10. The Bill specifies the requirements that must be met when making regulations under the Act, as well as amending regulations directly. The proposed Regulations give further direction on how to set the methodology and apply it during auctions.

## **Analysis and Advice**

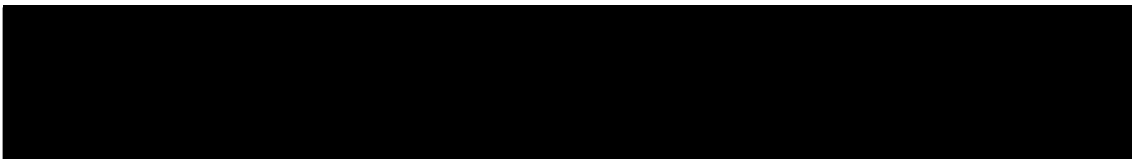
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*Recommended methodology should be simple and clearly meet the requirements of the Bill*

11. The purpose of the confidential reserve price, as defined in the Bill, is to prevent the sale of units in NZ ETS auctions at a price that is significantly below the secondary market price to avoid unduly influencing the secondary market and reduce the fiscal risk to the Government.

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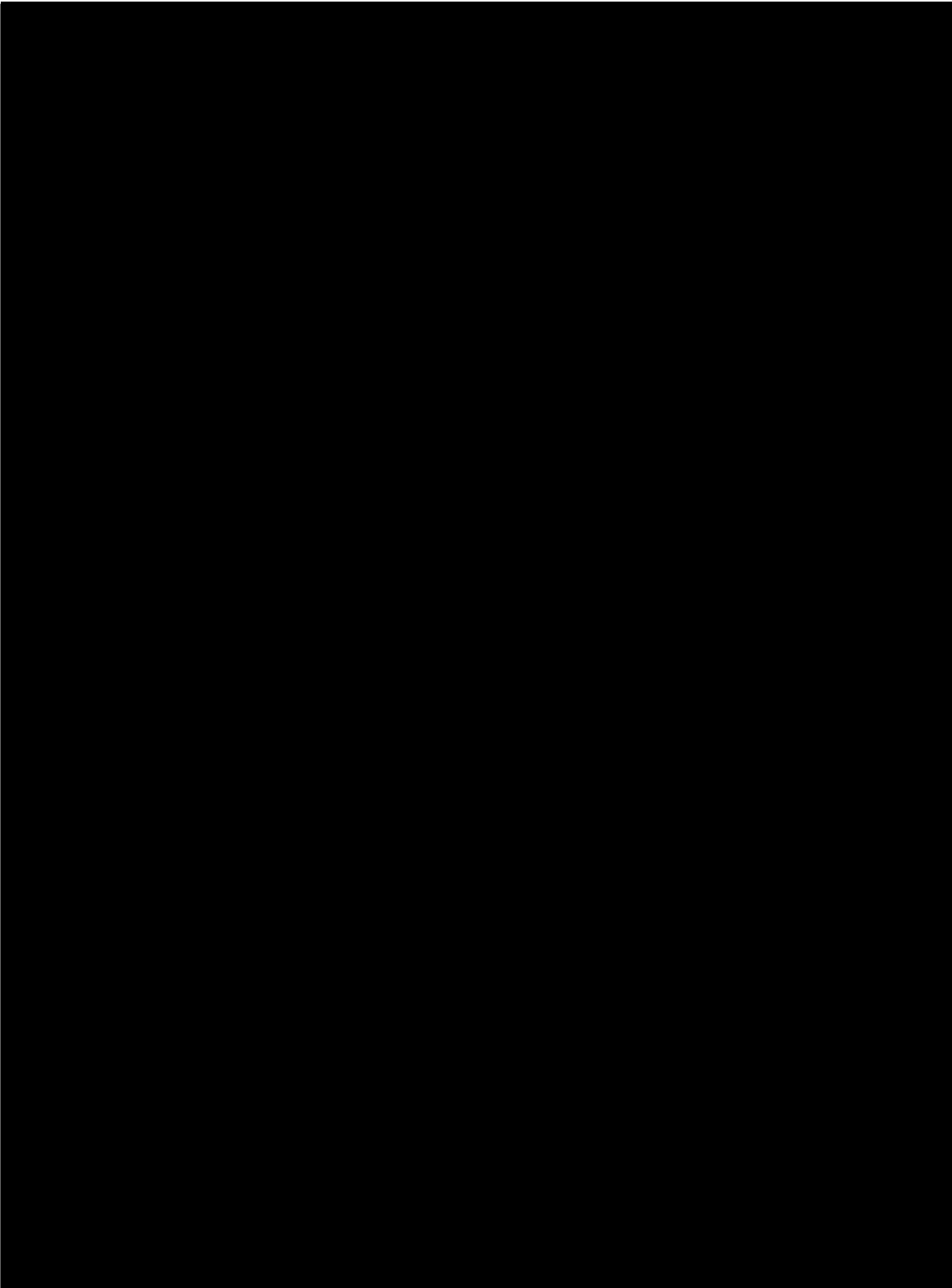
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13.  the following methodology has been developed for the NZ ETS confidential reserve price after considering its purpose, considering the other matters as outlined in the Bill and reflecting on other market examples and their expected outcomes for the NZ market.

*What needs to be considered when setting the methodology*

14. The proposed Regulations included in the Bill (new regulation 15A) specify that in setting the methodology the Minister must consider:
  - 14.1. the need for the methodology to include:
    - 14.1.1. a way to determine a representative price for New Zealand units sold on secondary markets recently before the auction, taking into account any volatility in prices
    - 14.1.2. a way to determine a price below the representative price that will achieve the purpose of the confidential reserve price
  - 14.2. the purpose of confidential reserve prices, which is to prevent sales by auction under section 6A of the Act at prices significantly below the prices of New Zealand units sold at the time in other ways (on secondary markets) so that the sales by auction do not unduly affect secondary markets
  - 14.3. the main matters and additional matters in section 30GC (4),(5) and (6) of the Act as listed in Table 1.
15. In the following paragraphs, and in table 1, this briefing advises how you can consider the matters listed above.

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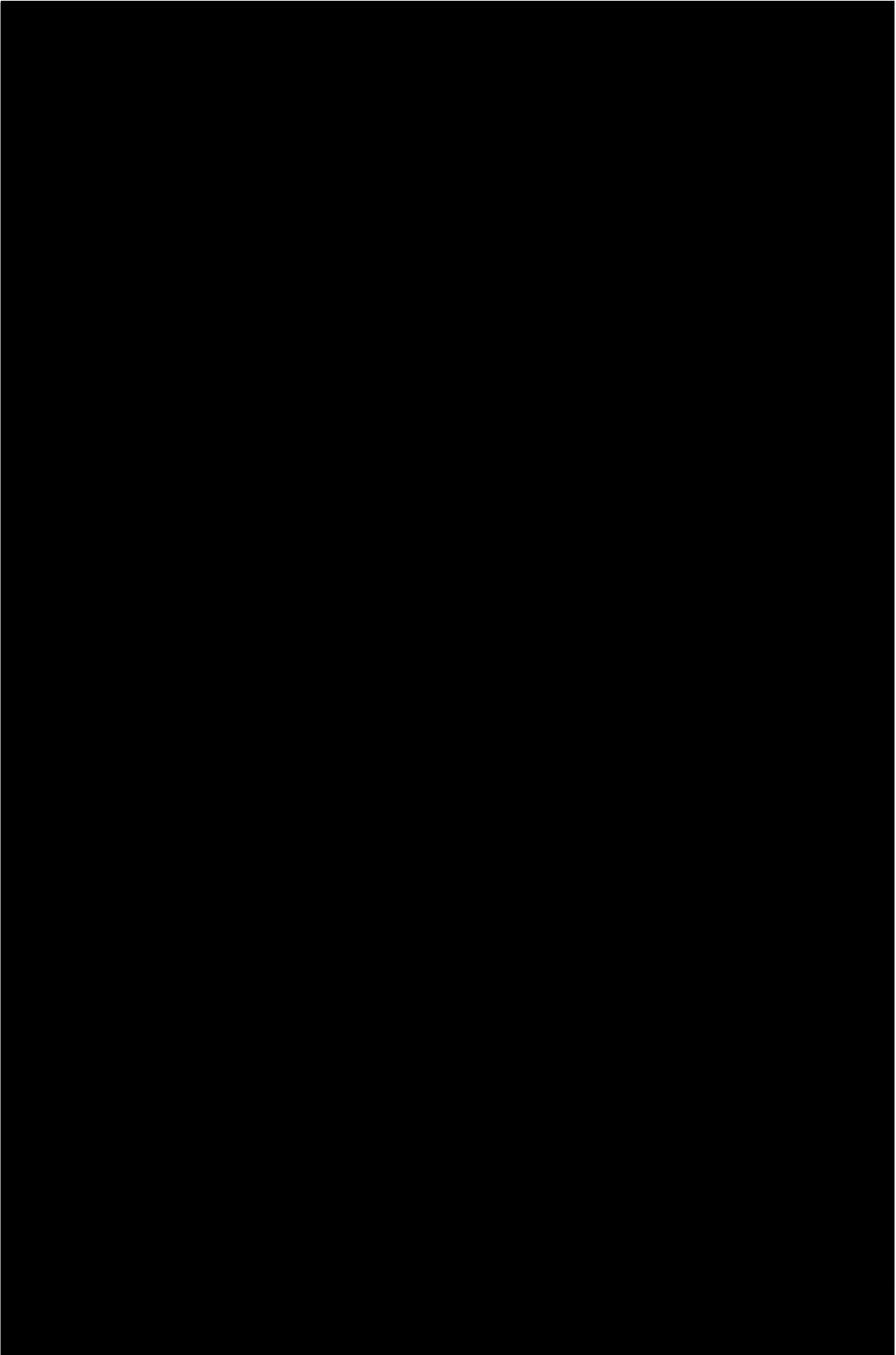


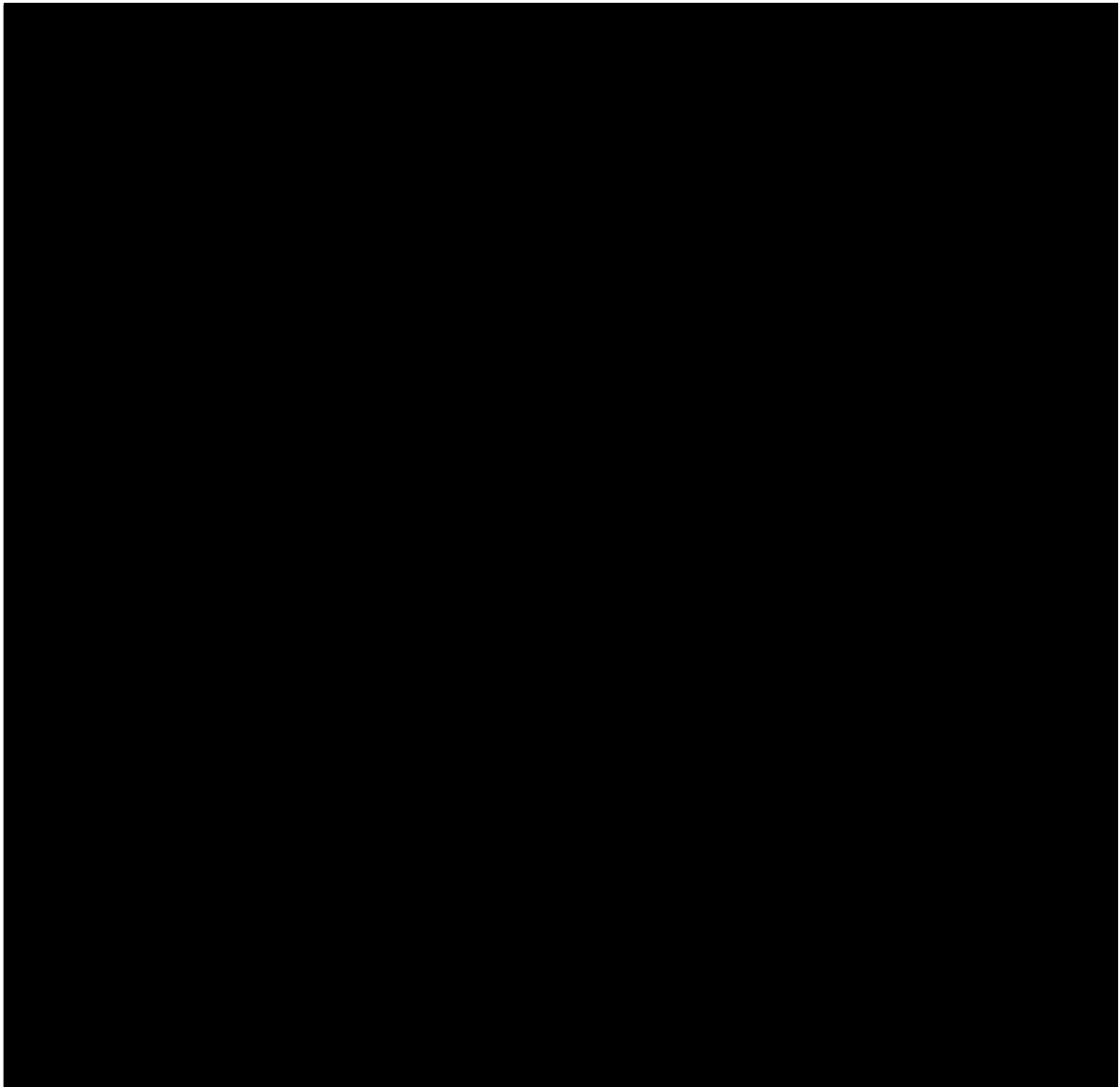
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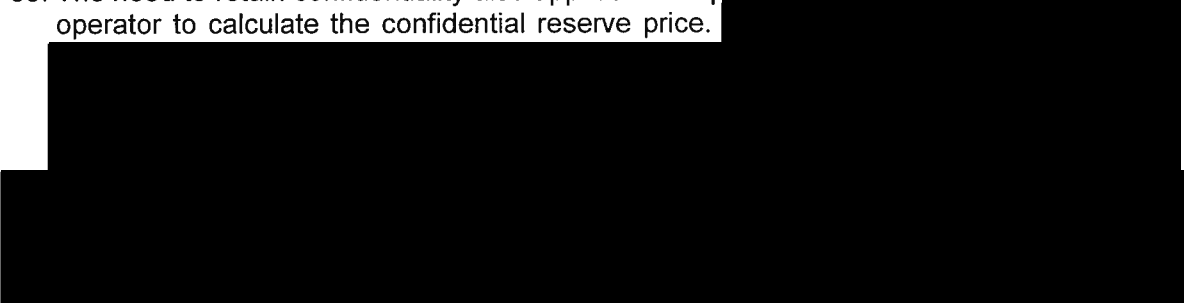




*Considering the requirement for confidentiality and the impact on the recommended methodology*

- 34. The methodology used to calculate the confidential reserve price needs to be kept confidential to ensure it does not become the target of bidding strategies by participants.
- 35. The need to retain confidentiality also applies to the price information used by the auction operator to calculate the confidential reserve price.

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<sup>3</sup> Provided that the next auction is scheduled for the same calendar year. Units cannot be rolled forward into the next calendar year because each year's auction volumes are fixed in regulations for the current and next year.



*The confidential reserve price prevents the sale of units if it exceeds the auction clearing price*

37. Once the value of the confidential reserve price for an auction has been calculated, if the interim clearing price for that auction does not reach or exceed the confidential reserve price then no units are sold at that auction.

38. If the confidential reserve price stops the sale of units at an auction then those units are rolled forward to the next auction in the year. So, in 2021 if the confidential reserve price is hit at the March auction then those 4.75 million units will be sold in June instead, which means there would be 9.5 million units for sale in June. Unsold units are not rolled over into the following calendar year. Refer to Appendix 1: Overview - NZ Emissions Trading Scheme auctions for charts of auction scenarios involving the confidential reserve price.

*Transitional arrangements in the Bill allow the first methodology to be set before enactment*

39. The Bill specifies that if the first methodology to calculate confidential reserve prices is set before the Bill is enacted then it can validly be used for NZ ETS auctions provided that the regulatory requirements have been met.

40. We have outlined in this briefing how this advice meets the relevant regulatory requirements.

*Considering the purpose of confidential reserve prices*

*Considering the main matters and additional matters under the Act*

41. The following table (Table 1) summarises how you can consider the main matters and additional matters in section 30GC of the Act.

**Table 1: Considering the main and additional matters under section 30GC of the Act**

Matters that must be considered under s 30GC (4)(5) and (6)	Description	Commentary	Advice
<p>New Zealand's projected greenhouse gas emissions, including the anticipated volume of emissions to which the ETS applies and the anticipated volume of emissions to which the scheme does not apply.</p>	<p>January 2021 projections show a gradual reduction in New Zealand's projected emissions under current policies (assuming a carbon price of \$35 per tonne of CO<sub>2</sub>e) from 62.7 Mt CO<sub>2</sub>e in 2020 to 39.4 Mt CO<sub>2</sub>e in 2050, representing a 37 per cent reduction on 2020 levels by 2050. The projections show that the gap between our projected emissions and New Zealand's targets under both the Paris agreement and the Act have narrowed but more work remains to be done.</p>	<p>Decisions on NZ ETS settings, to set the annual cap and price control limits were made in May 2020 for the operation of the NZ ETS for the period from 2021 to 2025 [ENV-20-MIN-0016]. As part of the annual regulations update process we will be providing advice to you later in 2021 on amendments to these settings, taking into account New Zealand's updated emissions projections and the recent advice of the Climate Change Commission.</p>	<p>For the purposes of setting the confidential reserve price methodology, the current emissions projections, ETS settings and draft Climate Change Commission advice indicate that the emissions price in the ETS market needs to rise in the short to medium term to provide a real incentive to reduce emissions.</p> <p>We advise that taking these criteria into consideration supports the need to set a confidential reserve price, both to support market stability and to prevent a significantly low clearing price from having a negative impact on secondary market price and therefore reduce the incentive to reduce emissions.</p> <p>Supporting market stability and maintaining the reputation and integrity of the NZ ETS is also important to support any future international linking agreements that may be required.</p>
<p>International obligations</p>	<p>To meet New Zealand's Nationally Determined Contribution (NDC) under the Paris Agreement, access to international units with environmental integrity will be needed to supplement domestic action. The Climate Change Commission's draft advice released on 1 February supports this view.</p>	<p>While the setting of a confidential reserve price does not directly impact the ability of New Zealand to meet its international climate change obligations, the reputation of the NZ ETS is important to our future ability to potentially negotiate linking arrangements with other ETS markets, should the Government decide to access international units in this way.</p>	
<p>Recommendations of the Climate Change Commission under the Act</p>	<p>The Commission's draft advice proposes more ambitious emissions budgets over time, retaining the limit on offshore mitigation use in emissions budgets of zero for the first three budgets and increasing the value of both the cost containment reserve price trigger and the price floor substantially and as soon as possible.</p>	<p>The ETS market itself has responded to the draft Climate Change Commission advice in recent weeks with a rise in price. NZUs are currently trading at approximately \$39.</p>	

Matters that must be considered under s 30GC (4)(5) and (6)	Description	Commentary	Advice
<p>The proper functioning of the ETS</p>	<p>The purpose of the NZ ETS in the Act is to support and encourage global efforts to reduce the emission of greenhouse gases by assisting New Zealand to meet its international obligations under the Paris Agreement and its 2050 target and emissions budgets</p>	<p>A significant divergence between auction prices and the prevailing secondary market price could cause reduced or volatile prices on the secondary market. This poses a significant risk to the integrity of auctioning specifically and the scheme as a whole. Furthermore, a significant divergence may impact on perceptions of the robustness, transparency, or efficacy of the NZ ETS.</p>	<p>We advise that setting a confidential reserve price can support the proper functioning of the ETS by setting clear expectations that auctions will clear in line with the secondary market, and reducing the risk that a significantly low clearing price could unduly influence that market.</p>
<p>The forecast availability and cost of ways to reduce greenhouse gas emissions that may be needed for New Zealand to meet its targets for the reduction of emissions</p>	<p>MfE is currently working to provide advice to you on the Emissions Reduction Plan, due at the end of 2021. Work is also underway to consider the impact of the draft Climate Change Commission advice on this plan.</p>	<p>Detailed analysis of the availability and costs of ways to reduce greenhouse gas emissions is in progress but will not be complete before this methodology is required to be set. Further advice will be provided to you when you are required to consider this to set the next round of ETS unit supply limits and price controls later this year.</p>	<p>We advise that due to timing issues, it is not possible to consider forecasts of these matters in detail at present. However, since the methodology can be changed at any time, should this matter become material to the setting of the confidential reserve price methodology, we can reconsider our advice when details of the Emissions Reduction Plan are decided.</p>
<p>The impact of emissions prices on households and the economy</p>	<p>The impact of emissions prices on households and the economy is unlikely to be materially affected by the methodology used to set a confidential reserve price. It is the trajectory of the emissions price in the market that has the greater impact.</p>	<p>The ability to set a confidential reserve price for auctions is designed to support market stability and predictability within the bounds of ETS price controls.</p>	<p>We advise that the confidential reserve price can contribute to a stable NZ ETS and that is better for households and the economy as it enables long term planning and supports emissions reductions.</p>

Matters that must be considered under s 30GC (4)(5) and (6)	Description	Commentary	Advice
<p>The level and trajectory of international emissions prices (including price controls in linked markets)</p>	<p>Prices in most international ETS markets have been relatively stable recently, with the exception of the EU where prices have been rising. EU emissions prices soared to record highs equivalent to \$63.77 NZD. The increases are attributed to the extremely cold winter temperatures putting pressure on the energy market.</p>	<p>The NZ ETS is currently a domestic only scheme and is not directly linked to any international emissions markets. Considering this matter will become more relevant to NZ ETS price controls and the operation of the confidential reserve price in the future if the Government decides to enter into international linking arrangements.</p>	<p>We advise that the level and trajectory of international emissions prices (including price controls in linked markets) are only likely to be relevant to the confidential reserve price methodology if they lead to increased price volatility in the NZ ETS secondary market. As secondary market volatility is required to be considered directly, international market movements are not immediately relevant.</p>
<p>Inflation</p>	<p>Currently inflation rates in New Zealand remain low, sitting at 1.4% for the year ended December 2020.</p>		<p>We advise that given the low rates of inflation at present, there are other factors that have more influence on emissions prices. The effects of inflation are not material to the methodology at present.</p>

## Consultation and Collaboration

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42. We have discussed the recommended methodology with the Treasury, and shared this briefing with them, to enable them to provide advice to the Minister of Finance.
43. We have consulted the auction operator, NZX, to ensure that [REDACTED] the recommended methodology is achievable in practice.

## Risks and mitigations

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### *Ensuring confidentiality of the methodology and the risk if it becomes known*

44. The methodology used to calculate the confidential reserve price needs to be kept confidential to ensure it does not become the target of bidding strategies by participants. Similarly, the price information used by the auction operator to calculate the confidential reserve price also needs to be kept confidential.
45. If the methodology were to become known and targeted then it is possible that auctions could consistently clear below the secondary market price, but just above the confidential reserve price. We consider this to be a low risk in practice, but it does also pose a fiscal risk to the Government, albeit smaller in scale than if there was no confidential reserve price.
46. If confidentiality was breached, the Government can review and change the methodology used to set the confidential reserve price at any time. This would require us to provide you with advice on how to amend the methodology and you to agree to a new methodology to be shared with the auction operator.

### *Risk of not setting a confidential reserve price, or setting it at a level where the auction still clears at a price significantly below the secondary market price*

47. If the auction clears significantly below the secondary market price, either because no confidential reserve price exists, or because it is set 'too low' then there is a risk that this could put downward pressure on the secondary market price and have reputational impacts on the NZ ETS.

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[REDACTED]

### *Risk of hitting the confidential reserve price*

49. If the confidential reserve price is hit at the first auction and prevents the sale of all units, then this is by design. It would reflect that the auction demand for units was not high enough at prices in line with the secondary market, and had prevented lower priced bids from setting the clearing price.
50. This raises the risk that ETS market participants may expect or rely on the 4.75 million units from the first auction becoming available. Unsuccessful bidders who need units for

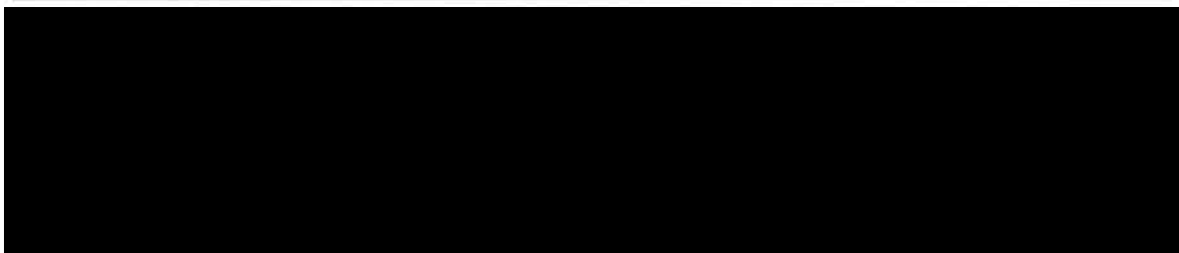
compliance purposes would then be required to purchase units on the secondary market or (for the 2020 compliance year only) make use of the \$35 fixed price option.

51. All units not sold in March would be rolled over to the June auction. The June auction would then have 9 million units for sale and there would be an increased focus on the outcome of the auction. There may be a small upside risk to the secondary market price in the meantime.

## Legal issues

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## Next Steps

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*The Auction Price Bill requires the Minister to consult with the Minister of Finance in setting the methodology*

53. We recommend that you forward this advice to the Minister of Finance to enable you to meet the requirement in the Bill to consult with him when setting the methodology for the confidential reserve price.
54. We recommend that you request a response from the Minister of Finance by 5 March 2021 to ensure the methodology can be agreed and confirmed to the auction operator at least ten days before the first auction date of 17 March 2021.

## Appendix 1 – Overview of New Zealand Emissions Trading Scheme auctions and the operation of the confidential reserve price

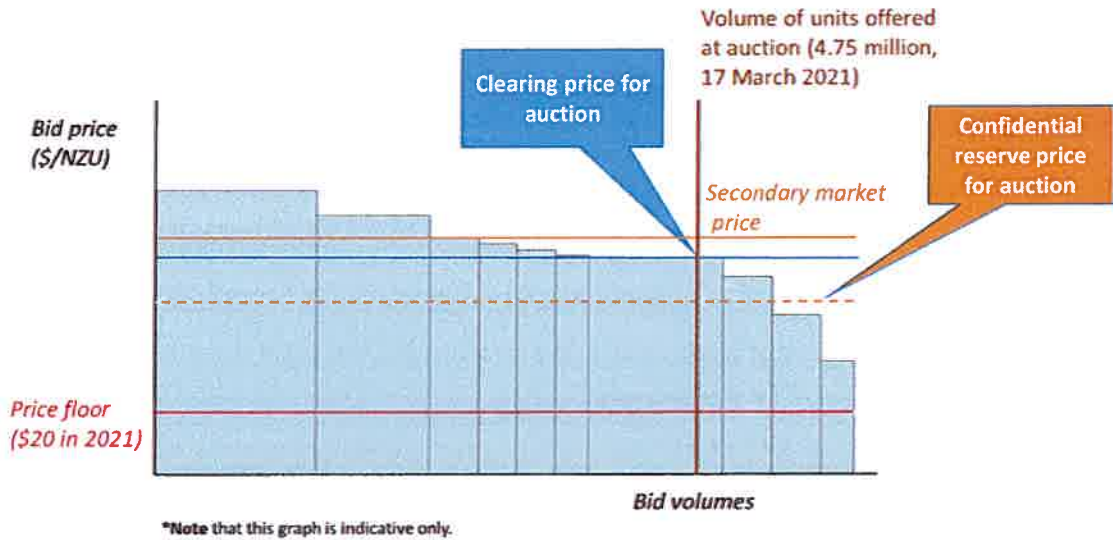
### *Overview of NZ ETS auction format and clearing price calculation*

1. The Government decided on the auction format for NZ ETS auctions at the beginning of the ETS reform process. The format is referred to as sealed bid, single-round, uniformly priced and is used in other overseas ETS markets. [ENV-18-MIN-0048 refers].
2. This auction format means that during auctions in the NZ ETS:
  - bidders can't see other bids (sealed-bid)
  - bidders submit bids once per auction (single-round)
  - successful bidders all pay the same auction clearing price (uniformly priced).
3. The auction clearing price is calculated as follows:
  - bidders submit a bid for a specified number of units at their preferred price
  - all bids are ranked in order from highest to lowest price
  - units are allocated to bids in descending order of bid price until all units are allocated or there are no more bids
  - the clearing price is the price of the lowest priced bid that receives units.
4. If there are bids for more units than are for sale (demand is greater than supply), then the clearing price will be set by the bid that buys the last unit. For example, in an auction selling 4.75 million units, if bids are received for 10 million units, ranging in price from \$40 to \$25 and the bid that buys the 4.75 millionth unit (when bids are ranked in descending order of price) was priced at \$30, then the clearing price is \$30.
5. If there are bids for fewer units than are for sale (demand is less than supply) then the clearing price is the price of the lowest price bid. For example, if bids are received for 2 million units when 4.75 million are for sale and bid prices range from \$40 to \$25 then the clearing price is \$25 (assuming no confidential reserve applies).
6. Auctioning is only one source of supply to the NZ ETS market. Other sources of supply include industrial allocation and the issuance of units for forestry and other, removals. The majority of demand for units will continue to be supplied by the secondary market which is open for trading daily.
7. The following charts illustrate two scenarios that may occur in auctions where a confidential reserve price applies.

### *Auction clears above the confidential reserve price*

8. The first chart below (Figure 1) shows an auction where demand is high and there are bids for more units than are for sale. The offset margin gives a confidential reserve price well below the clearing price and all the units are sold.

**Figure 1: Demand greater than supply, auction clears above confidential reserve price, all NZUs sold at clearing price.**

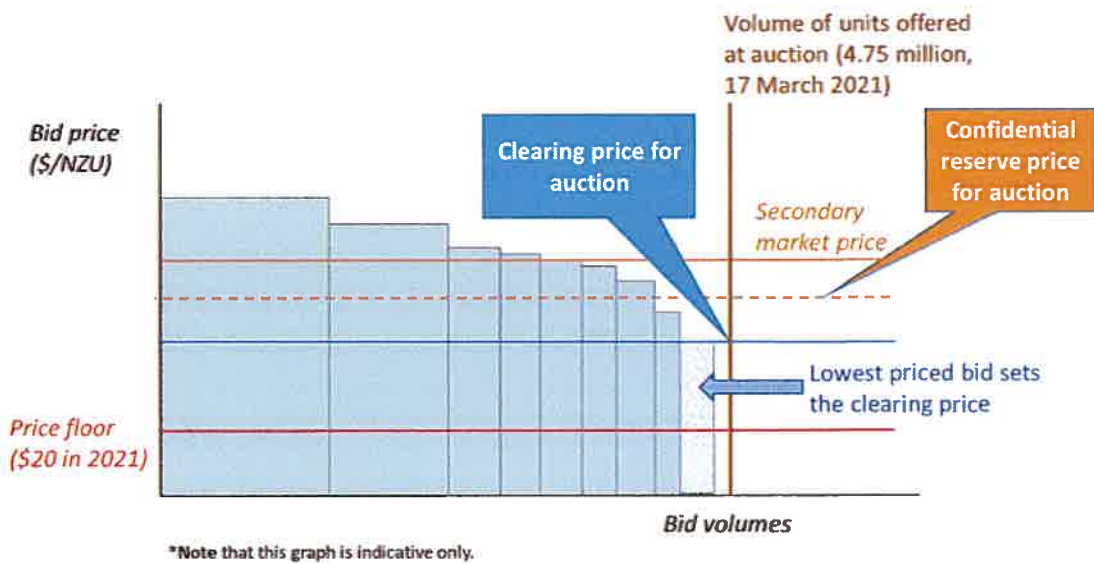


9. A variation on the scenario shown in Figure 1 could occur when the bid that sets the clearing price falls below the confidential reserve price. In that situation, no units would be sold. This scenario is less likely in an auction where demand is high.

*Auction does not sell units because the confidential reserve price is greater than the clearing price*

10. The second chart (Figure 2) shows an auction where demand is low and the final clearing price is below the confidential reserve price. There are not enough bids to buy all the units. The final bid sets the price. In this situation none of the units are sold. This is a less likely scenario, but it is possible in a market where demand for the units at auction is lower than expected.

**Figure 2: Demand less than supply, auction does not clear above confidential reserve price, NZUs not sold.**



11. A variation on the scenario shown in Figure 2 could occur in a low demand auction if the lowest price bid is still greater than the confidential reserve price. With a lowest bid price above the confidential reserve price the auction would proceed, and all bids would be sold units at the final bid price. The small number of units that remained unsold would then be sold at the next auction.

