The Continuing Development of the Global Carbon Credits Markets

March 2022 Commentary

Shortly following the launch of the **Ninepoint Carbon Credit ETF** on Feb 16, Russia's military invasion of Ukraine triggered unprecedented volatility in global carbon credit markets. On March 14, we posted a special commentary on a wild two weeks for the world, and for carbon credits.

Investment Team

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Equity markets, initially pressured by fears over 40-year highs in inflation, rising interest rates and Russia's invasion of Ukraine recovered much of their YTD losses in March. The S&P 500 finished the month with a total return up 2.1%, largely based on optimism about a potential peace deal between Russia and Ukraine.

The global carbon market has posted mixed returns. In Europe, the EUA posted a -7.0% end of month loss. After an almost 40% recovery from its March 14 lows, the European trading scheme has been moving sideways around $80 as trading activity cools down.

The price discovery continues: the EUA posted a series of daily gains amid optimistic reports from negotiations between Russia and Ukraine, while selling pressure also occurred as a result of the quarterly options contract expiry.

Most notably, on March 28, the European Securities and Markets Authority (ESMA), the EU's securities markets regulator, published its final report on its analysis of the EU emissions allowances trading.

In the report, ESMA analyzed EU carbon market trading data and concluded that "*overall, ESMA considers that the data analysis has not unearthed any major abnormality or fundamental issue in the functioning of the EU carbon market from a financial supervisory perspective. The observed evolution of carbon prices and volatility seem to have followed market fundamentals.*"[1] Some other key findings and policy recommendations from the report are covered below.

In North America, CCA prices continued to recover from the massive early-month plunge and ended the month with a 4.1% gain; RGGI Allowances posted a 6.4% loss after the release of Q1 auction results and the uncertainty around Virginia's future in RGGI as Republicans pushes to withdraw the state from the cap-and-trade program.

Figure 1: Performance of Major Carbon Markets (Mar 1 - Mar 31)

	Cumulative Return (Mar 1 - Mar 31)	Daily Volatility (Mar 1 – Mar 31)
ICE EUA Carbon Futures Index (ER)	-7.0%	6.2%
ICE CCA Carbon Futures Index (ER)	4.1%	3.3%
ICE RGGI Carbon Futures Index (ER)	-6.4%	1.7%
ICE UKA Carbon Futures Index (ER)	-4.8%	3.7%

Source: Bloomberg

Canada releases new climate roadmap to cut carbon emissions 40% by 2030

To achieve the ambitious greenhouse gas targets by 2030, on March 29, 2022, the Canadian government released their updated emissions reduction plan, "*2030 Emissions Reduction Plan – Canada's Next Steps for Clean Air and a Strong Economy*", to dramatically control greenhouse gas emissions across all parts of the economy over the next eight years. This plan, among many other initiatives, increased the rate at which carbon prices will rise going forward.

The carbon price in Canada was set to $20/ton in 2019 and has been rising by $10/ton since then, reaching $50/ton this year. **The new plan will increase the carbon price by $15/ton beginning in 2023 until it reaches $170/ton in 2030**. In our view, the carbon price schedule being implemented in Canada is consistent with emission reduction targets in other developed market jurisdictions and supports our view that carbon credit pricing is positioned to move considerably higher over the coming years.

EU's securities markets regulator publishes its final report on EU carbon trading

In 2021, the European Commission asked the European Securities and Markets Authority (ESMA), the EU's securities markets regulator, to examine trading behaviours of the EU emissions allowances (EUA) in order to address the questions raised around the functioning of the European carbon market.

On March 28, 2022, ESMA published its final report based on data obtained from different sources, including EMIR reporting, MiFIR transaction reporting, MiFID II daily and weekly position reports, auction data and data obtained from the EU Registry[1]. The price developments up to March 4, 2022 were incorporated in the report, which reflected the price impact the Ukraine war has on the EUA.

Below are the key findings from the report:

- long positions in carbon derivatives are mainly held by non-financial entities for hedging purposes;
- short positions are mainly held by banks and investment firms providing liquidity and carbon financing;
- positions by investment funds remain limited, with positions principally held by third country funds; and
- the share of high-frequency and algorithmic trading is significant in the carbon market, even if the relevant firms are only holding very small or no actual positions.[1]

A number of policy recommendations are provided to ensure the transparency of the EU carbon

market:

- extend position management controls to EUA derivatives;
- amend EUA position reporting;
- track chain of transactions in MiFIR regulatory reports; and
- provide ESMA with access to primary market transactions.[1]

The report finding is not surprising to us. According to the report, at the end of 2021, the share of EUA future positions held by investment funds only accounted for 5% of the total open positions and is continuing shrinking going into 2022, indicating that the carbon price development and volatility seem to have followed what it is intended to be[1].

The ongoing policy support from the EU further reinforced our view that the emissions trading system is a key tool of for countries to achieve the overall objective of reducing net greenhouse gas emissions, and that financial market participation is essential to drive the true price discovery of carbon. As we closely follow the EU's response to the recommendations proposed in the report, we would like to emphasize the importance of diversification in managing an emerging asset class like carbon credits.

Ninepoint Carbon Credit ETF adds United Kingdom Allowances (UKA)

Ninepoint Carbon Credit ETF recently added United Kingdom Allowances ("UKA") following our quarterly rebalancing at the end of March. By allocating to all four of the world's most liquid carbon futures markets we are improving diversification for investors and making the Fund more reflective of global carbon markets.

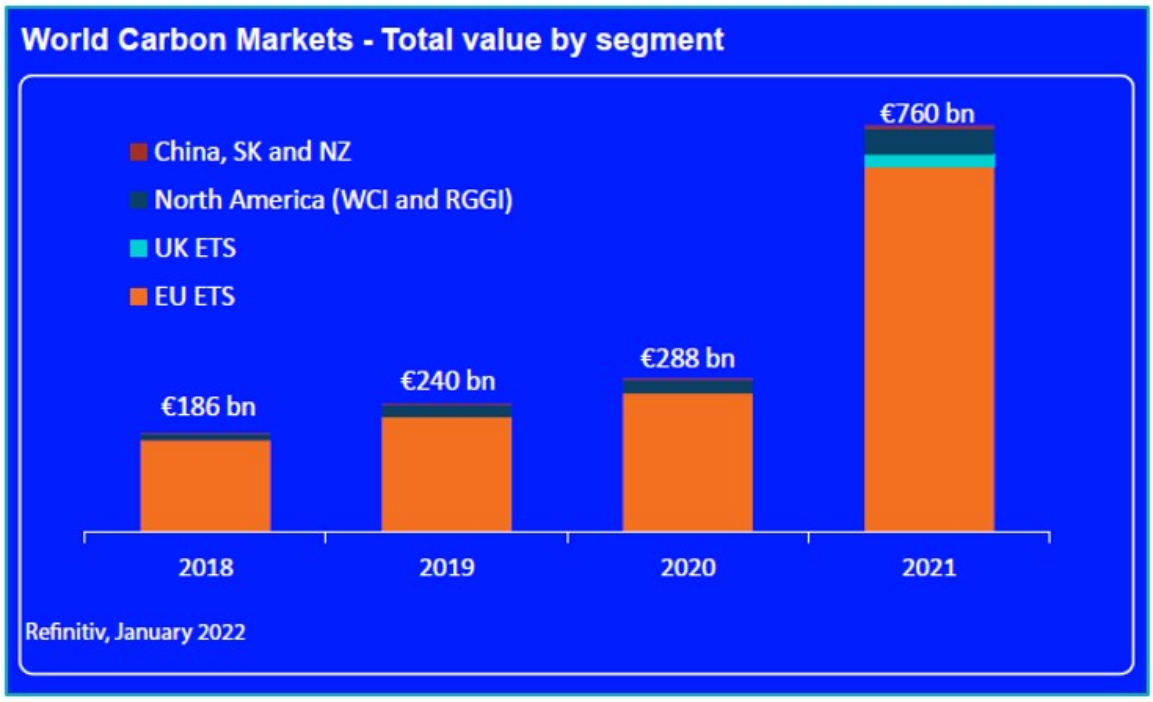
The investment objective of Ninepoint Carbon Credit ETF is to seek to provide unitholders with long-term capital appreciation by investing primarily in global carbon emissions allowance futures. As the global carbon credit market grows, the fund may invest in additional carbon allowance futures contracts.

United Kingdom Allowances ("UKA")

As a replacement for the UK's participation in the EU emissions trading system (ETS), the new UK emissions trading system came into operation on January 1, 2021. The allowances trading under the UK ETS are referred to as United Kingdom Allowances (UKA). The first auction under the UK ETS took place on May 19, 2021 through the ICE.

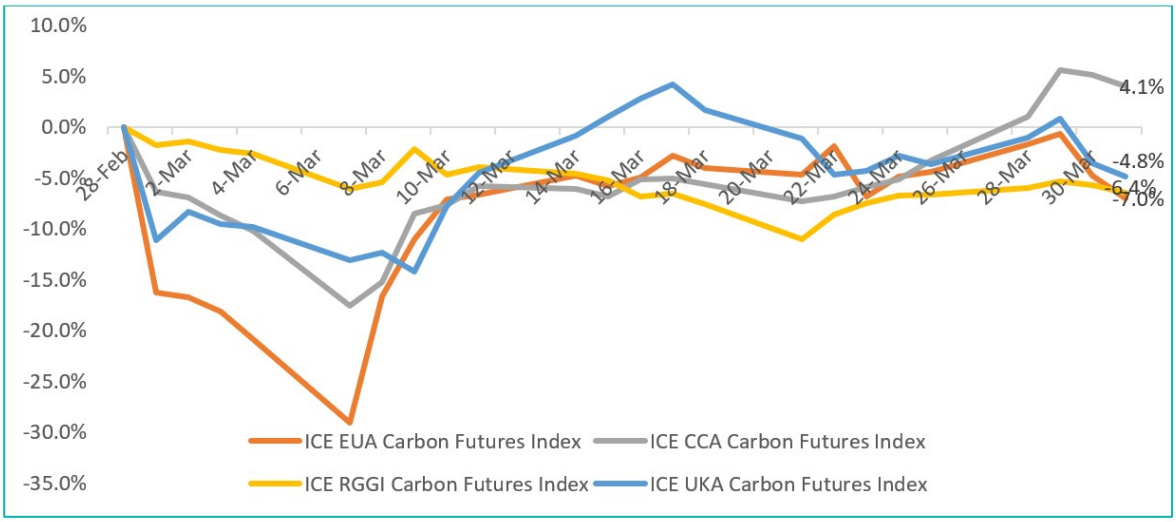
The UK ETS currently covers approximately 2,000 installations in the power generation sector, aviation, and other energy intensive industries, similar to the scope of the EU ETS. According to Refinitiv, a total traded volume of 335 Mt UKAs transacted in 2021[2] , making it the third most liquid ETS market globally, after EUA and CCA.

Figure 2: Global Carbon Markets - Total Value by Segment



Source: Refinitiv

Figure 3: Global Carbon Markets - Cumulative Returns (Mar 1 - Mar 31)



Source: Bloomberg

Figure 4: Global Carbon Markets - Correlation (Mar 1 - Mar 31)

	ICE EUA Carbon Futures Index	ICE CCA Carbon Futures Index	ICE RGGI Carbon Futures Index	ICE UKA Carbon Futures Index
ICE EUA Carbon Futures Index	1.00			
ICE CCA Carbon Futures Index	0.73	1.00		
ICE RGGI Carbon Futures Index	0.44	0.69	1.00	
ICE UKA Carbon Futures Index	0.57	0.48	0.10	1.00

Source: Bloomberg

Following this rebalancing, the Ninepoint Carbon Credit ETF now allows market participants to access a basket of four of the world's most liquid carbon futures markets: the European Union Allowances (EUA); the California Carbon Allowances (CCA); the UK Allowances (UKA); and the Regional Greenhouse Gas Initiative Allowances (RGGI).

The fund's new base weightings are as follows:

- EUA: 25%
- CCA: 25%
- RGGI: 25%
- UKA: 25%

Why Ninepoint Carbon Credit ETF?

For an emerging asset class like carbon credit, volatility management is at the heart of our fund strategy. At the moment, the Ninepoint Carbon Credit ETF invests equally in the four major ETS markets globally with quarterly rebalancing. This strategy has demonstrated remarkable resilience in the unprecedented recent carbon market volatility.

Reasons for investors to consider Ninepoint Carbon Credit ETF

Diversification - Balanced exposure to all carbon credit markets can help minimize single jurisdiction risk by eliminating over-concentration to any single market, as recent market action has demonstrated. Having a diversified underlying market portfolio is important for an emerging asset class with volatile price patterns, like carbon credits.

Global Exposure – The fund provides investors with access to a US$851 billion global carbon credit market which has grown by 18x since 20172. Compared to volume-weighted fund or funds that invest in one single market, we believe that our equal-weighted fund strategy has a better value proposition, over the long-term, given its overweight to the under-represented and rapidly growing carbon credit trading markets.

Core Value - As a Canadian fund, by overweighting the North American market relative to its total index weight, we are aligning our strategy with our values and our local community.

Easy Access - The fund is structured as an alternative mutual fund offering Series A, F, S, SF, Q, QF, D on Fundserv and as an ETF series on the NEO Exchange (NEO:CBON / CBON.U).

[1]ESMA publishes its Final Report on the EU Carbon Market

[2]Carbon Market Year In Review 2021

[1]All returns and fund details are a) based on Series F $USD units; b) net of fees; c) annualized if period is greater than one year; d) as at March 31, 2022.
[2]Sector allocation as at March 31, 2022. Sector allocation based on % of net asset value. Numbers may not add up due to rounding. Cash and cash equivalents include non-portfolio assets and/or liabilities.

The Ninepoint Carbon Credit ETF is generally exposed to the following risks See the prospectus of the Fund for a description of these risks Absence of an active market for ETF Series risk, cap and trade risk, collateral risk, commodity risk, concentration risk, cybersecurity risk, derivatives risk, foreign currency risk, foreign investment risk, Halted trading of ETF Series risk, inflation risk, interest rate risk, liquidity risk, market risk, regulatory risk, securities lending, repurchase and reverse repurchase transactions risk, series risk, substantial securityholder risk, tax risk, trading price of etf series risk.

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