

U.S. Flue-Cured Tobacco Situation and Outlook

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Thank you very much, it's good to be here in Pitt County with you today. I am not an advocate, I am just an analyst. I get to work with a very diverse group of people, and that is part of the enjoyment of the job. I work mostly with farmers and farm groups on policy issues, but I also get to work with health advocacy groups. And, I get to work a lot with legislators and with industries. So I tell folks that I try to make everybody a little bit uncomfortable—a little bit mad—so that no body will feel that I am biased toward any group.

I want to talk about the tobacco situation from more of a domestic standpoint. But, you cannot do that without talking about some of the global impact, so I am going to cover some of Dan Stevens' material. I will skip through some of this fairly quickly, though, because what I would like to do is get towards the end of my presentation and talk about issues for farmers. In particular, I want to address the sort of business planning can you do under the situation of uncertainty that we have.

The Domestic Tobacco Situation

If we look back at the 2001 season, there are a couple of things I will note. Prices were quite good at about \$1.86 a pound. That is higher than normal. Very little of the crop went to the cooperative. I know Dan went over the quota system so I am not going to say much about that. The thing that is very different is the fact that we used to talk about different kinds of belts: the old and middle belt, the eastern belt, the border belt, the Georgia/Florida

belt. Now we have southern contracts, northern contracts, southern auctions, and northern auctions. About 80% of the flue-cured tobacco produced last year was sold through contracts. The marketing system has gone through a very dramatic shift within the last two years. Most of the shift took place last year, when sales basically switched from an auction system to a contract system. These contracts are basically marketing contracts very similar to the way cotton or other agricultural commodities are sold. This is a change that has been a long time coming, and quite frankly, it is a little surprising that it took so long to come to tobacco. Most agricultural production shifted to systems of direct sales and marketing contracts long ago. The thing that folks are waiting to see is how long this contract system will continue to be solely a marketing contract. This arrangement involves the least intervention by the company that is doing the contracting. Alternatively, will the new sales system evolve into more of a quasi-production contract similar to what you have with some vegetables, and, of course, poultry and hogs? I do not think it will ever go to quite that extent.

All right, let me talk about the cigarette market, because it is very important for what is happening today. Basically the significant thing that has happened in the US cigarette market is the Master Settlement Agreement (MSA), which is, of course, where the money for this meeting today came from. The reason that this is significant is that it did two things. First, it instituted a series of basically in-perpetuity pay-

ments from cigarette manufacturers to states that agreed to settle with, and not sue, the company at any time in the future. Second, the payments have raised the cost of cigarettes, which has been passed on to the consumers.

Another aspect that is very important is that in reaching a settlement, the states essentially granted cigarette manufacturers a large degree of market power, which has had two consequences. First, states placed themselves in a position where their Attorneys General offices now have to enforce barriers to entry into cigarette marketing, because there is a big incentive for new cigarette manufactures to come on board. This is a huge issue in terms of the Master Settlement Agreement. Secondly, states have placed themselves in a position in which they receive much less money if cigarette consumption declines. To some extent, it is ironic that things were set up in this way. But, if you look at court cases, and if you look at all the analyses that have been done, it becomes apparent that cigarette manufacturers have been granted some cartel power through this MSA. And so what we have seen is a rapid escalation in cigarette prices since 1997. Prices have

risen from \$1.95 a pack to somewhere around \$3.50 to \$3.60 a pack at the first of this year. (See Figure 1.) The cost of the MSA to cigarette manufacturers, depending on how you model cigarette consumption, is probably somewhere between 30 and 70 cents per pack. Cigarette prices have increased considerably more than the actual cost of the MSA, which is a very interesting situation. I work a lot with the State Attorneys General offices, and we are doing a big study for the Tobacco Trust Fund Commission. It has been a very interesting process to understand more about this settlement and how it works. And, it will be interesting to see how it plays out, particularly regarding the barriers to entry to new manufacturers.

If you look at the US cigarette market (Figure 2), domestic consumption has been declining fairly steadily. There was a price decrease about 1993 and a sort of leveling off and then a slight increase in cigarette consumption. This happened after what has been called 'Marlboro Friday', when Phillip Morris dramatically dropped the prices of Marlboro cigarettes. Then in 1998 the MSA went into effect, and prices began to escalate fairly rapidly as I noted ear-

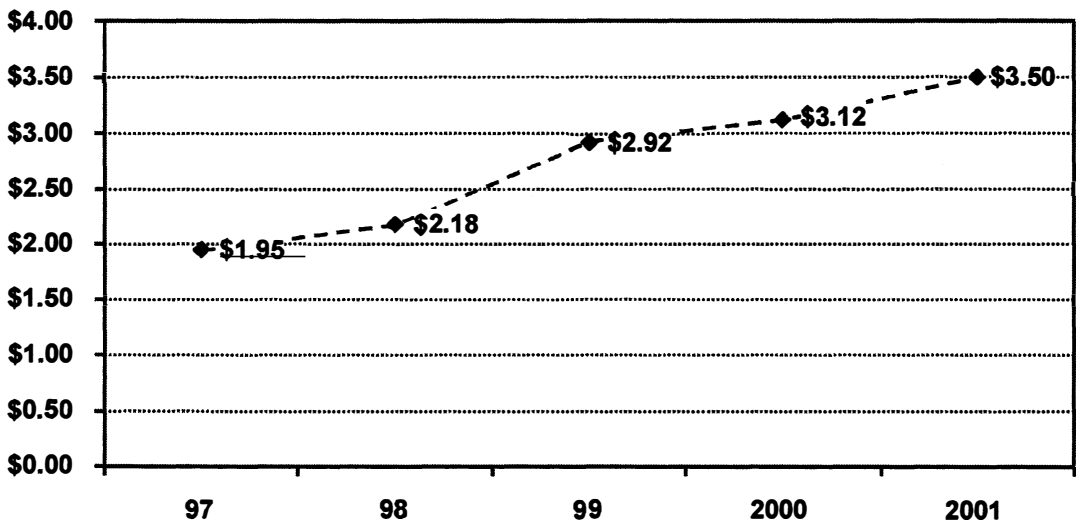


Figure 1. Average US Retail Cigarette Price (November of Each Year)

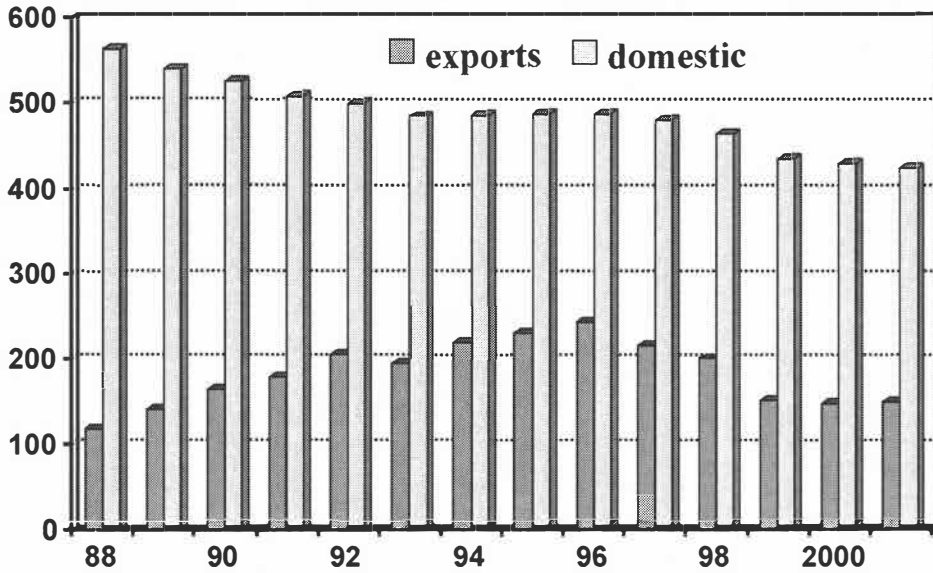


Figure 2. US Cigarette Market

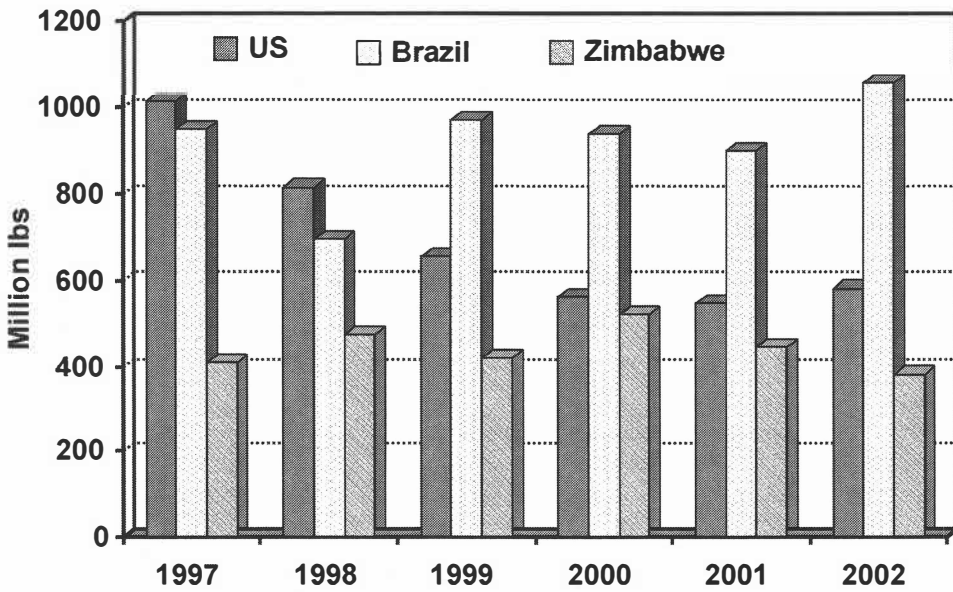


Figure 3. Flue-Cured Tobacco Production

lier. Because of this, cigarette consumption decreased fairly rapidly for a couple of years, and now it seems to be leveling off again. One of the things that has been surprising to economists like myself who are trying to model this consumption is that it has been even less sensitive to the price change than we thought it would be. Consumption has not decreased as much as some forecasts would indicate.

The other part that is very significant here, especially to tobacco farmers, is the decline in cigarette exports. Cigarette exports reached a historical high in 1996. The US produced more cigarettes in 1996 than ever in history, but since then production has declined from about 250 billion cigarettes to about 150 billion. This, of course, has had a very significant impact not only at the farm level, but also at a manufacturing level. When we look at the impact on the North Carolina economy, we always talk about the farm level, but we must also think about the huge impact in the Piedmont-Triad area, where a lot of cigarette manufacturing takes place.

Dan Stevens spent a lot of time talking about something that I want to revisit here because it is very important to US tobacco growers. Despite being a global commodity, there is less intervention from the US government in local markets than there is for any other commodity (such as cotton, for example, which is one I study). Figure 3 shows flue-cured tobacco production for the US, Brazil and Zimbabwe. These are basically the three producers of high value, high quality flue-cured tobacco. The competition between these three producers in the world market is very intense. Although there are many other producers, most do not compete in terms of quality with these three. This graph illustrates that US production is declining dramatically as our quota has decreased since 1997. Zimbabwe is kind of bumping along, and now it looks like Zimbabwe is going to decline because of the political turmoil there, and also because of the land redistribution program that the government is trying to implement. Brazil has been trying to

make up the slack.

Now remember, this is a global market. Leaf merchants and cigarette manufacturers are global corporations. The task of leaf merchants is to go out and contract farmers around the world, to decide where the best tobacco will be produced and to try to meet the demand for that tobacco. One of the things merchants are struggling with is the difficult political situation in Zimbabwe. Companies will have to rethink their position there in the future, and decide where they will relocate. Well, if the US Tobacco Program stays in place, obviously a company will want to put more of its operation where it already has a lot of production, and that is in Brazil. But, if you have a scenario in which the US program were to be eliminated through a tobacco buyout or some other measure, then a company will likely put more of its investment here, spreading itself between Brazil and the US. You can see the dilemma that companies like Dimon, Universal, and Standard Commercial, all of which are very important to this eastern economy, face. The dilemma they are facing is trying to plan where to place their investment in capital facilities.

The next aspect to consider is flue-cured disappearance (use). I am not going to spend a lot of time on this other than to say that Figure 4 indicates that domestic disappearance is somewhat erratic but basically trends downward with US consumption. It has been particularly affected in the last few years by the decline in both US consumption and in cigarette exports. In terms of unmanufactured tobacco exports, especially in the 1970s when the US had a virtual monopoly on premium type flue-cured tobacco, US exports were actually at or above the amount sold domestically. In the 1980s, however, as Zimbabwe reentered the market after its civil war, and as Brazil entered the market as a new producer of premium flue-cured tobacco, US exports declined to below the level of domestic sales. Dan's graph [Figure 6, p. 5] showed a little bit of an up-take after the US price was lowered

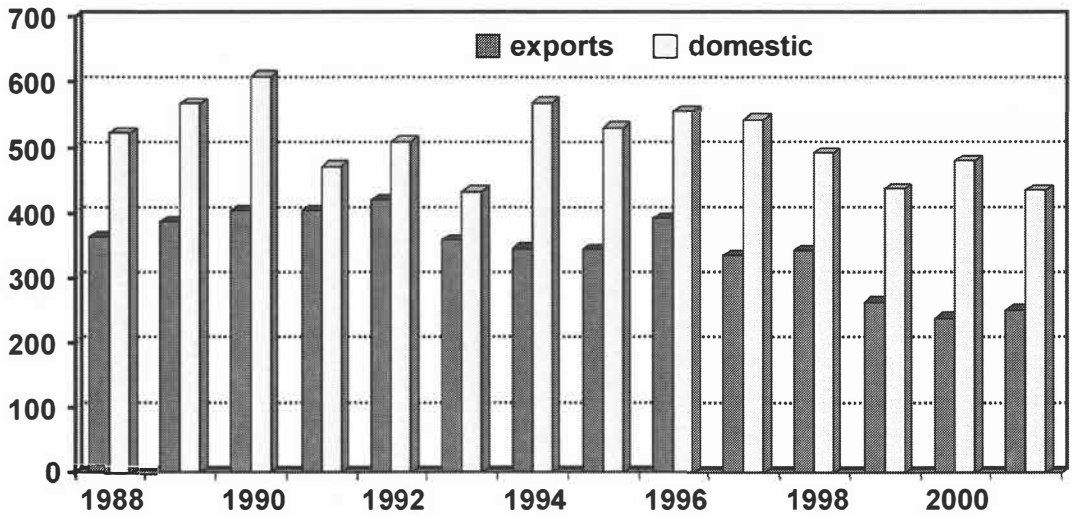


Figure 4. Flue-Cured Disappearance

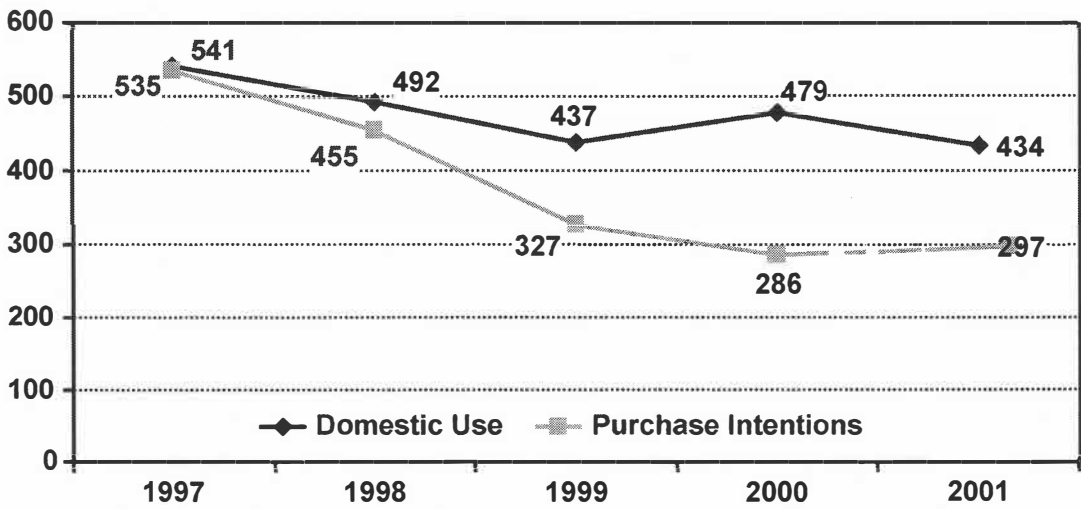


Figure 5. Domestic Use and Purchase Intentions for US Flue-Cured Tobacco

in the mid 1980s, and now since the mid 1990s we see a gradual decline with some very disturbing declines in unmanufactured export in recent years. The situation in Zimbabwe may help stabilize that for the US, but right now, as Dan mentioned, the US is not in a position to recapture any of that market. Most of that has been moving toward Brazil.

Let me just point out one thing about domestic use and purchase intentions of flue-cured tobacco before we move on to some other issues (see Figure 5.) One of the notable aspects of the purchase intention portion of the quota that Dan showed you earlier is that for the last two or three years, purchase intentions have been well below the amount of tobacco that US tobacco companies have actually been using. They have been using more US tobacco than they have been purchasing. What has been going on with the Master Settlement Agreement, and with the expectation of higher prices and lower cigarette consumption, is an anticipated need of less tobacco in the future. Well, tobacco manufacturers hold roughly 18 months to two years worth of tobacco in storage. So, if one anticipates using less tobacco in the future, in the short run there will be a need to pull down inventories. This is because if a company has been holding two years' worth of tobacco and starts using less, it might end up with a surplus unless its inventories are lowered. Pulling down inventories in the short run means buying considerably less tobacco than what is actually used. Now, I tell farmers that the bright spot in this is the fact that once companies adjust their inventories, purchase intentions come back in line with the amount companies are actually using. The amount companies are using, of course, is declining towards 400 or maybe even well below 400 million pounds, but it also indicates that the purchase intentions have the possibility, at least, of increasing back up to 350 million pounds or at least to the point where they meet usage.

I am not going to say much about the quota. Dan discussed that. But, the quota basi-

cally is still under 600 million pounds. This year it is 582 million pounds. If the US program stays in place we could see that quota come back towards 600 million pounds. And, perhaps with what is going on in Zimbabwe, exports will stabilize a little bit. Now recall the average quota in the early 1990s was about 870-880 million pounds, which is well below where US markets were 5 to 8 years ago. But, this might be a stable level for at least the foreseeable future.

The Tobacco Buyout: Consensus

The big issue, of course, is the tobacco buyout (see Figure 6). When is it? When is the money coming? I would say that there are several things going on, and I am sure Commissioner Phipps probably alluded to some of the work the Department of Agriculture is doing in this area. Essentially, the first thing that is required, which is not easy, is to reach some sort consensus among the burley and flue-cured growers and quota owners in both areas. That is not easy to do because each group has different interests.

The second thing, which is just as difficult, is that there will have to be some sort of consensus among cigarette manufacturers. Yes, they would all like to buy tobacco cheaper. No, they all do not agree on how to accomplish this. The prime issue here is FDA regulations, which one large manufacturer wants, and the rest say, "ain't no way." Another point is the consent of health advocacy groups. They can stop a buyout if they do not like it—that is, for example, if they think that it will mean the US is going to grow tobacco everywhere unconstrained or if they think it is going to benefit cigarette manufacturers. These kinds of differences are very important because they can derail this thing very quickly, so their consent will be needed. So the question is: What kind of consensus can be reached in which everybody is willing to participate? Again, this is not easy, but it is what legislators are working on. I know Senator Helms' office and Senator McConnell's office (of Kentucky) are both working very hard on

- **Consensus:**
 1. Among Burley and Flue-Cured Growers
 2. Among Cigarette Manufacturers
- **Consent of Health Advocacy Groups**
- **Funding Sources:**
 1. Excise Tax Increase
 2. Capture the Existing Excise Tax
 3. Phase II Funds
 4. Cigarette Manufacturers
- **FDA Regulations?**
- **A Tobacco Program after a Buyout?**
- **Requires Federal Legislation**

Figure 6. Considerations in a Buyout

this issue behind the scene.

The next big question is: how do you fund a buyout? If you are talking about \$8 (for quota owners) and \$4 (for growers), which is the figure everybody likes to talk about, where will that kind of money come from? Congress did fund the peanut buyout. The peanut program is changing from a quota program to a commodity-type program, which cost \$4 billion. But, a lot of states are involved in peanuts—Texas being one of them—and peanuts are not generally viewed as problem-ridden. It is a very different issue to get federal money for a \$4 billion peanut buyout than it is to get \$20 billion for a tobacco buyout. First, there is the issue of political support, and second, the image of peanuts is just different from tobacco. So, federal funding as a budget line item is probably not an option. The idea of an excise tax increase was promoted early on. This is probably a deal stopper, though, because getting a consensus on this from the various groups involved, or even among tobacco state legislators, is likely to be difficult.

Richard Burr, a Congressman from the Winston-Salem area, proposed capturing the existing excise tax. He had a 5-cent excise tax already going into place this year. He suggested

just capturing it, using it for a few years, and then giving it back to the government to use for whatever it wanted later. This was really a good idea, probably one of the best ones proposed that I have seen. The only problem was that September 11th changed everything. We went from having a projected surplus to having projected deficits. So, capturing that tax became basically impossible. Walter Jones is a co-sponsor of that deal by the way.

Phase II funds is another option.¹ If there is a buyout, my guess is that Phase II funds will be pulled into it. The agreement was written up in such a way that if there is a buyout, cigarette companies ante-up some way to fund this thing, or find a way to fund it through user fees on smokers. My guess is Phase II will be part of it. Now, this is just a trade off. Some folks will argue that it is good based on the way these Phase II funds have been allocated, and some folks will argue that it is a terrible thing. Some states are more inclined towards this option, and some state are very opposed. So again, this is an issue that causes some tension, which makes a consensus somewhat more difficult to reach.

Lastly, is the option that the funds have to somehow come through cigarette manufacturers. Perhaps this will be through some sort of user fee that the government instates. Somehow this source of funding will have to allow manufacturers to pass this cost on to consumers. The idea that is being talked about a lot now is the user fee, which may be a vehicle that can be put in place. It is actually a quasi tax, but it does not have the same ramifications as an increased excise tax. So, there are several proposals in the works. People ask what the probability of a buyout is. I say, well it is greater than zero. I really don't know what the probability is. Some days it seems like it is closer to 50%, and some days it feels like it's a lot less than that. So we will just have to wait and see.

I already mentioned FDA regulations, a very important issue and also one that makes it quite difficult to reach a consensus. The other re-

lated issue is: if the tobacco program is eliminated, what do we have in its place? Will tobacco get a commodity program like peanuts got? Probably not. It would be a very expensive program to operate—a lot more expensive than the quota program that is currently in place, because it would not be a no-net cost program, which is what our current tobacco program basically is.

Well what could be done? Kentucky really wants some sort of production control program to keep tobacco from leaving the state. Health advocates want some sort of production control to ensure that we do not just grow tobacco everywhere. Some producers want some sort of production control to keep other states from producing tobacco. So I do not know what the outcome of that will be, but I know it will not be easy. Most North Carolina farm policy organizations say, "Let's get a buyout and then we will worry about whether we have a program later." Most of the Kentucky organizations basically want to get a buyout and keep the program they have. That probably will not happen. You cannot get paid for something and keep it. So this is another very difficult issue to reach consensus on.

What I would like to remind you of is the fact that all of this requires federal legislation. We are seeing a lot of work done in other areas, which is all good and may help bring about a consensus. These efforts may help states come to a consensus, but the bottom line is this is something that your Senators and Congresspersons have to do, and then the US President has to sign off on it. You cannot forget that. That is a very important part, which also does not make a change in the program easy.

Future Prospects

After hearing me say all these things you may feel we might as well give up hope, but, no, I do not think so. I think it is still a possibility, I just do not know how probable it is. Given all these factors, then, what does the future

hold? This is what I often talk to farmers about. If you are a farmer or if you are an agricultural business that is dependent on tobacco, how do you plan? Let us think about two scenarios for your business and then think about how will you plan under these two scenarios (Figure 7).

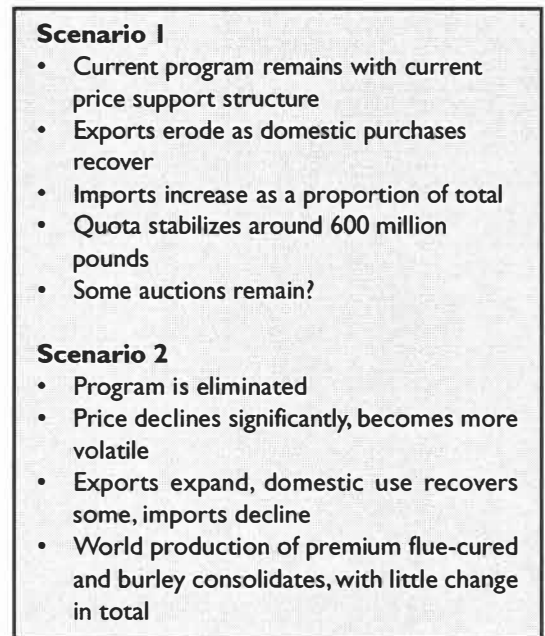


Figure 7. What Does the Future Hold?

The first scenario is that the current program remains with the current price support structure. Exports will continue to erode some as domestic purchases recover a bit, so maybe you can see the quota stabilize somewhere around 600 million pounds, at least for the next few years. Over the long term, we probably would continue to see erosion, but in the short term we might anticipate the 600 million pounds or so mark. Most tobacco will continue to be sold via contracts. My guess is that as long as the program is in place and there is a price support, some auction markets will continue, and that will serve as a venue to apply a price

support (unless, of course, grading gets voted in—then I think that grading may be enforced at the buying stations, which may eliminate some of the need for auction markets). This is one scenario—things go along like they are for a little while longer.

The second scenario is that the program is eliminated, through a buyout or otherwise. The price declines significantly. What it will decline to is a question we are trying to analyze right now (Wally Thurman and I did a big study on this in 1995-96, and we are in the process of updating that study of what will happen if the program is eliminated. We are very fortunate to be funded by the North Carolina Tobacco Research Commission, which basically consists of tobacco growers). If the program is eliminated during a period when inventory is pretty low, or if there is not a surplus supply of tobacco (as is the case right now), then the price of tobacco will fall fairly slowly. It probably will go to \$1.45 in the first year or two, and then as supply gradually expands, it will go on in a sort of orderly manner on down towards \$1.20, which will most likely be an equilibrium price. On the other hand, if the program is eliminated during a period of large surplus supply in the world market, which we have from time to time, then prices will decline very rapidly towards that much lower level. So it matters when a buyout takes place.

Timing is also a matter in terms of how much exports expand. If we wait until the market share of Zimbabwe is reallocated toward investment in Brazil, most likely it will then be much more difficult to grab some of that market share, even if the US price declines. If the program is eliminated now during this time of turmoil in Zimbabwe, when companies, merchants and others are trying to decide how to reallocate their investments, then there is a much better chance of the US recapturing some of the export market because most of the price sensitive buyers have left the market. We are down to a hard core of cigarette manufacturers, some from northern Europe, who buy

US tobacco regardless of the price. However, we will probably return a point where many of the more price sensitive buyers will begin to buy some US tobacco, and leaf merchants will probably like to have some diversification on premium. They do not want to have all their eggs in Brazil. Given a choice, they will prefer to spread their investments around a bit. This is just good business sense.

So, exports would expand, domestic use would recover some, although I do not think domestic cigarette manufacturers are very responsive to price, because it is not a real price responsive market. Imports will decline. World production of premium, flue-cured and burley tobacco will consolidate. We will see more consolidation, primarily in Brazil and the US. The US will not take Brazil's market share away. Brazil's share is very, very, very solid. The only thing that would change this is if something happened to the Brazilian government; if there was political unrest or inflation or something like that. But you will not see much change in the total. The pie is set; it is not going to get bigger. The issue is how it will break up among different countries. US and North Carolina production would expand. Our forecast on the preliminary results we got on this model says production in flue-cured tobacco will easily go above 900 million pounds. Frankly, this is a little surprising to me under the current circumstances. I thought it would be lower than that. So I think it is not unreasonable to think that if this were to happen, US flue-cured production would move back up to the 900 million to 1 billion-pound mark as prices decline.

In terms of North Carolina, production will decline in the Piedmont, but in the eastern part of the state, farmers will not have too much to worry about for now. This is a very competitive tobacco-producing region. It will still earn higher returns, and you will see a lot of tobacco grown here. In fact, one of the things that Kentucky is worried about is the prospect that, as flue-cured production declines in our Piedmont region and no controls on produc-

tion exist, growers in the Piedmont will shift to growing burley tobacco. North Carolina could easily double its tobacco production under this scenario. Whether you like that or dislike it depends on which side of the issue you stand. But those are the facts. It will be a very viable commodity here that will compete very well.

Consolidation of growers, though, will be accelerated, so we will see fewer growers growing more tobacco. I do not think they will be huge growers. Rather, they will be middle-sized growers, probably 100 to 200-acre growers. This is the likely size range of a stable unit that will work well for companies to maintain the kind of quality they want. We will see increased specialization of tobacco farmers. We will not see the diversification on farms that we see now. The reason for this is that tobacco is a very management-intensive crop, and some farmers will specialize in tobacco production because that will be the most profitable thing for them to do. They will drop the other commodities that they grow currently

because they have not been allowed to grow as much tobacco as they would like. Other farmers will move out of tobacco and will specialize in cotton or peanuts. I think peanuts have the potential to be a very important commodity in some counties that have not been growing quite as much as Pitt County, for example, has. We are going to see a lot of structural change, which I think is an outcome that surprises most folks. But, when you think about the way farms would have to operate in a new market situation, it should not be surprising at all. And, of course, the last question is: will there be some compensation for growers in this? Hopefully there will be compensation through some sort of buyout.

¹ Phase II funds were set up under the Master Settlement Agreement to compensate tobacco growers and quota owners for losses incurred as a result of the Master Settlement Agreement.