

## Commodity Spotlight



## Tobacco Industry Downsizing, Restructuring

A recent dramatic shift from auctioning to contract selling in the tobacco market is changing the character of the industry. In addition, already-existing restrictions on smoking areas and advertising and the growing consciousness of the health risks of smoking are having a long-term effect on the industry.

Among tobacco producing nations, the U.S. ranks third in output behind China and Brazil. A major exporter of tobacco leaf, the U.S. ranks second behind Brazil, after many years of being the largest exporter. Paradoxically, the U.S. also imports more tobacco leaf than any other country. To achieve economical blends with desired smoking characteristics, U.S. manufacturers import lower quality leaf from overseas to blend with domestic leaf. The U.S. is the second-largest manufacturer of cigarettes after China, and the largest exporter. About a third of cigarettes produced in the U.S. are exported.

Of the 16 states that grow tobacco, North Carolina and Kentucky account for 67 percent of total U.S. volume. Annual marketings of tobacco leaf total about 1 billion pounds. Although tobacco acreage is small compared with many other crops, it is a high-value crop, ranking ninth in value of production, just behind potatoes.

Flue-cured tobacco accounts for 65 percent of tobacco produced in the U.S.; burley makes up the remainder. Flue-cured tobacco is so named because it is cured in an airtight barn or container with a flue or chimney exposing the leaf to heat. Burley

tobacco is cured by hanging the entire plant in an open-sided barn exposing the leaf to the atmosphere. Nearly all, 93 percent, of tobacco output is used for cigarettes. The remaining 7 percent is used for cigars, snuff, chewing tobacco, and loose smoking tobacco.

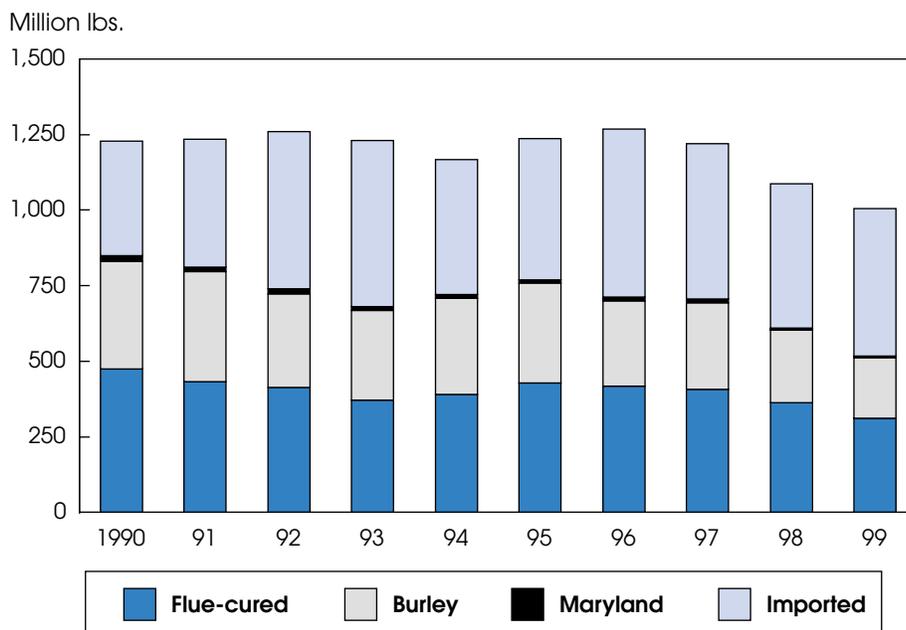
### *Contracting Is Revolutionizing Tobacco Marketing*

Auction markets have dominated tobacco marketing since the 1800s. Many towns and cities in the Southeast depend not only on tobacco production for their livelihood but also on the marketing of tobacco.

As the dominant crop in both small and large southeastern towns, tobacco auctions represent more than just a means of marketing tobacco. The opening of the auction markets has been a traditional day of celebration that brought together the entire community. It was an occasion for parades and gatherings, and promoted a sense of community in a way other agricultural commodities did not.

The Tobacco Inspection Act of 1935 mandated inspection and market news services at auction markets designated by the

### Portion of Imported Tobacco in Domestic Cigarettes Rising



Economic Research Service, USDA

## USDA Tobacco Program in Brief

The USDA tobacco program consists of marketing quotas and price supports. Growers of each type of tobacco vote every 3 years whether or not that type of tobacco will be part of the program. The outcome is applied to all growers of that type of tobacco. Flue-cured and burley producers have approved the program every year except one since 1938.

Marketing quotas under the program determine the quantity of tobacco a producer is allowed to sell each season. The Agricultural Adjustment Act of 1938 (as amended over the years) provides that total flue-cured and burley basic quotas equal the sum of 1) the buying intentions of domestic cigarette manufacturers, 2) the 3-year average of unmanufactured tobacco exports, and 3) adjustments of loan association inventories needed to reach the specified reserve stock level. The Secretary of Agriculture may adjust this three-part total either up or down by a maximum of 3 percent.

The effective quota determines the quantity of tobacco a producer may sell. The effective quota for each type of tobacco is the basic quota adjusted by the individual marketings from previous seasons for each quota holder. Overmarketings and undermarketings carried over in each season can be as much as 3 percent of that year's effective quota.

Price supports are the other component of the tobacco program. They enhance the income-stabilizing capacity of quotas by providing a minimum or floor price for each grade of leaf. Knowing what floor price to expect well ahead of the tobacco season helps producers make informed planting decisions. Since 1987, the annual flue-cured and burley price support has been the level for the preceding year, adjusted by changes in the 5-year moving average of prices (two-thirds weight) and in the cost of production index (one-third weight). Costs include variable costs, but exclude costs of land, quota, risk, overhead, management, marketing contributions or assessments, and other costs not directly related to tobacco production. The Secretary can set the price support between 65 and 100 percent of the calculated adjusted change from the previous year.

Support prices are guaranteed through nonrecourse loans that are available on each farmer's marketed crop. Each grade of flue-cured and burley tobacco is assigned a support price. In 2001, the flue-cured support price averaged \$1.66 for each pound of tobacco. The support price for burley was \$1.83 per pound. Loan rates range from \$1.24 to \$1.92 per pound,

depending on grade, for flue-cured and \$1.14 to \$1.85 per pound for burley. Price supports for other supported types of tobacco range from \$1.25 to \$1.74 per pound. Price supports for each grade are announced before the auction season begins.

At the auction sale barn, each individual lot of tobacco is sold to the highest bidder, unless bids do not exceed the government's loan price. If the bid is below the loan price, the farmer may accept the support price (loan rate) from a designated cooperative. The tobacco is consigned to the cooperative (known as a price stabilization cooperative), which redries, packs, and stores the tobacco as collateral for USDA's Commodity Credit Corporation (CCC). The cooperative later sells the tobacco and the proceeds are used to repay the CCC loan plus interest.

Since 1982, no-net-cost assessments cover projected losses to the CCC in operating the tobacco price-support program. U.S. flue-cured and burley growers have paid no-net-cost fees since 1982, while purchasers have paid fees on U.S.-grown tobacco since 1986. Beginning in 1994, no-net-cost assessments have been levied on importers of flue-cured and burley tobacco.

Both flue-cured and burley reserve stock levels are currently lower than they might have been because of legislation forgiving CCC loans on 1999-crop tobacco. Because the loans are forgiven, this tobacco (88 million pounds of flue-cured and 230 million pounds of burley) is not considered part of the reserve stock component of the quota calculation and has been effectively removed from the supply of leaf available for use by the tobacco industry. It is likely this tobacco will be destroyed. Legislation forbids selling the tobacco domestically, and international trade agreements will make it difficult to export.

Repaying the CCC \$637 million for the 1999 loan stocks means the government will have large expenditures for the tobacco program that would normally be covered by the no-net-cost assessments. However, without the forgiveness of the loans, quotas would have fallen further since the reserve stocks would have been high and the consequent negative adjustment to the quota formula would have been large. Additionally, the cost of carrying the 1999 tobacco would ultimately have been borne by the growers in the no-net-cost assessment, lowering grower income.

Secretary of Agriculture. Since the inception of the tobacco program in 1938, nonrecourse loans known as price supports have been available for many types of tobacco. To receive price support, however, leaf must be sold in USDA-approved auction warehouses and inspected by USDA graders.

Tobacco has been sold at auctions because, unlike many commodities, tobacco leaf is not a homogeneous product that can be graded by taking a moisture sample or observing color. The qualities that make tobacco leaf desirable are less tangible. The feel of the leaf is important, but so are its smell and color. Elasticity of the

leaf is considered, among many other characteristics. Individual buyers require markedly different leaf characteristics, depending on the final use.

Until recently, tobacco was sold in small lots called sheets. A sheet of tobacco is a square piece of burlap with up to 250

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pounds of leaf wrapped in it. The four corners of the sheet can be tied together so the tobacco can be easily moved and transported. Untied, the tobacco can be easily inspected by graders and buyers.

In the past decade, bales have become more popular as a means of marketing tobacco. A bale consists of about 700 pounds of compressed tobacco. Bales permit more efficient movement of tobacco through the marketing chain.

### *Contracting Supplants Auctions in 2001*

Cigarette manufacturers have been proposing contract marketing as an alternative to auction markets for a number of years. Manufacturers assert that auction markets are not providing the combination of grades and characteristics they need to manufacture cigarettes. By contracting directly with leaf producers, manufacturers will have more influence over what qualities of leaf are available. These factors are more critical today because lower quotas mean less tobacco is produced, shrinking the pool from which manufacturers can pick and choose in their search for needed grades.

Most contracts are marketing contracts, not production contracts, and stipulate a delivery point and other details of the transaction. Some current contracts give the grower the right to reject the price offered under the contract and sell the leaf at auction.

During the 2000 marketing season (July 2000-June 2001), flue-cured leaf sold under contract accounted for about 50 million pounds out of a total 564 million pounds sold. Burley producers sold 87 million out of 311 million pounds through contracts outside of auction warehouse channels.

The magnitude of contract sales in 2001 has turned tobacco markets upside down. Flue-cured growers sold 440 million pounds through contracts out of a total 545 million pounds, or 81 percent of total sales. Burley growers began selling leaf in early November, and after 3 weeks of sales, 73 out of 111 million pounds were sold under contract.

### Domestic Cigarette Prices Soar After Master Settlement Agreement



\*Master Settlement Agreement limited manufacturers' advertisements and mandated payments to states for costs of treating smoking-related illnesses and reducing underage smoking.

Economic Research Service, USDA

The dramatic shift to contract marketing has had a significant impact on tobacco warehouses. In North Carolina alone, 69 of the 129 warehouses closed before the season began. It is estimated that 28 out of 78 warehouses may close in Kentucky.

Some warehouses have become collection centers for companies buying under contracts. Warehouses were already suffering from 3 years of large quota cuts that reduced the quantity of leaf they marketed and caused some less competitive warehouses to close. An additional 60- to 80-percent reduction in the amount of leaf available at auction will leave so little tobacco that it may not be economically viable for most warehouses to remain in business.

Contracting also calls the future of the tobacco program into question. For many years some types of tobacco in the program have been sold mainly through contracts. When selling under contract, growers relinquish their right to price support but are still bound by the marketing quota for their type of tobacco.

Many growers feel that without auction markets the tobacco program will become obsolete. And, if auctions cease to exist, many producers fear that contract buyers

may lower leaf prices and growers would then face lower incomes. However, contracting appeals to many growers because they are paid immediately. The contract price currently exceeds expected auction prices, and all of a grower's leaf is sold to one buyer in one transaction. Growers selling under contract avoid paying warehouse commissions and fees.

### *Cigarette Output & Consumption Continue Steady Decline*

The cigarette industry has stabilized after higher prices and tax increases during the past few years. Declining tobacco leaf production has also led to lower cigarette production. Cigarette output in 2000 reached 594.7 billion pieces, below 1999 but higher than expected. Domestic taxable removals (the volume of cigarettes for which manufacturers paid tax and subsequently shipped) totaled 423.3 billion pieces compared with 429.8 billion in 1999. Exports for the year were 148.3 billion pieces, 3.1 billion fewer than 1999.

In 2000, cigarette consumption slipped 5 billion pieces (250 million packs) to 430 billion pieces (21.5 billion packs of 20 cigarettes), continuing the long-term slide since peaking in 1981. Higher prices and taxes have been a major cause of declin-

ing cigarette consumption. Manufacturers raised wholesale cigarette prices twice in 2001, so continued declines are expected. Cigarette consumption in 2001 is forecast at 425 billion pieces, or 21.3 billion packs.

During the past decade, numerous states have increased cigarette taxes. Taxes range from 2.5 cents per pack in Virginia to \$1.41 in Oregon. In 2001, Maine raised its cigarette tax from 74 cents to \$1 per pack and Rhode Island raised its tax from 71 cents to \$1. Wisconsin's cigarette tax increased from 59 cents per pack to 77 cents. As a result of a voter referendum, Washington's cigarette tax will increase as of January 1, 2002, from 82 cents per pack to \$1.42, making it the highest in the nation. As of July 2001, 20 states have tax rates of at least 50 cents per pack, and six states have rates \$1 or greater. Virginia and Kentucky remain the lowest cigarette taxing states at 2.5 and 3 cents per pack.

Cigarette exports peaked in 1996 at 244 billion pieces. Since then, declining consumption in some importing countries and movement of U.S. production offshore have reduced U.S. cigarette shipments to about 150 billion in 1999, 2000, and 2001. Japan, Saudi Arabia, Cyprus, and the European Union are major buyers of U.S. cigarettes.

The impact of the Master Settlement Agreement (MSA) between cigarette manufacturers and state attorneys general continues to be another agent of change. The MSA, signed November 1998, further limited advertisements by manufacturers and mandated payments to states for the costs of treating smoking-related illnesses and reducing underage smoking.

After the MSA, cigarette manufacturers raised prices to cover the costs of the settlement and passed them on to consumers. In November 1998 when the agreement was signed, manufacturers raised cigarette prices 45 cents per pack, the largest increase ever.

In spite of the price increases and the restrictions resulting from the MSA, the proportion of Americans who smoke remains fairly steady, at about 25 percent. But smokers are smoking less. Annual per capita consumption has dropped from 2,834 cigarettes per adult over age 18 in 1991 to 2,014 in 2000 (includes smokers and nonsmokers). Restrictions on where people can smoke, higher prices, advertising restrictions, and greater awareness of health risks are having a long-term effect on the tobacco industry. **AO**

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[www.ers.usda.gov/publications/so/view.asp?f=/economics/ao-bb/](http://www.ers.usda.gov/publications/so/view.asp?f=/economics/ao-bb/)

### January Releases—National Agricultural Statistics Service

The following reports are issued electronically at 3 p.m. (ET) unless otherwise indicated.

[www.ers.usda.gov/nass/pubs/pubs.htm](http://www.ers.usda.gov/nass/pubs/pubs.htm)

#### January

- 3** Weather - Crop Summary (noon)  
Broiler Hatchery
- 4** Dairy Products Prices (8:30 a.m.)  
Milkfat Prices (8:30 a.m.)  
Dairy Products  
Poultry Slaughter
- 8** Weather - Crop Summary (noon)
- 9** Broiler Hatchery
- 10** Turkeys Raised  
Vegetables
- 11** Cotton Ginnings (8:30 a.m.)  
Crop Production (8:30 a.m.)  
Crop Production - Ann. (8:30 a.m.)  
Dairy Products Prices (8:30 a.m.)  
Grain Stocks (8:30 a.m.)  
Rice Stocks (8:30 a.m.)  
Winter Wheat Seedings (8:30 a.m.)
- 14** Egg Products  
Turkey Hatchery
- 15** Weather - Crop Summary (noon)
- 16** Broiler Hatchery  
Potato Stocks
- 17** Milk Production
- 18** Dairy Products Prices (8:30 a.m.)  
Milkfat Prices (8:30 a.m.)  
Cattle on Feed  
Cold Storage
- 22** Catfish Processing  
Monthly Agnews
- 23** Weather - Crop Summary (noon)  
Broiler Hatchery
- 25** Cotton Ginnings (8:30 a.m.)  
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Livestock Slaughter  
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- 29** Weather - Crop Summary (noon)  
Chickens and Eggs - Ann.  
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- 30** Broiler Hatchery  
Peanut Stocks and Processing
- 31** Agricultural Prices  
Chickens and Eggs