



REGIONAL RESOURCE

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Contracting in Tobacco

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In 1999, Philip Morris announced its intention to begin contracting directly with U.S. tobacco farmers. Coming as it did in the midst of a massive slide in tobacco quotas, this decision was viewed by many American tobacco farmers as more bad news. In response to grower concerns, Philip Morris delayed its partnering program until the 2000 season, when it contracted with burley tobacco growers for more than 80 million pounds of tobacco. In addition, RJ Reynolds and Star Scientific contracted for low-nitrosamine flue-cured tobacco in 2000 as well, amounting to a little more than 50 million pounds. All of the major tobacco companies have announced plans to purchase tobacco directly from growers through contracts in the 2001 season. A shift from the traditional auction system to a direct marketing system has major implications for growers, auction warehouses and tobacco communities. This *Regional Resource* provides some background on contracting in agriculture in general and offers some perspective on how it has been applied in tobacco. This report also addresses some of the potential impacts a shift to contract production would have on tobacco farming.

What Is Contracting?

A contract is a legally binding agreement between two or more parties involving an enforceable promise. Contracts in business usually relate to the supply of goods or services at a prearranged or fixed price. Contracts in any sector are intended to reduce risks and stabilize quality and price fluctuations for both producers and processors. In agriculture, contracts between farmers and processors or other farmers are an increasingly common marketing option, with a considerable amount of production coming under contract every year.

Contracts in agriculture vary in their complexity, terms, conditions and scope depending on the commodity involved and even within the commodity where specific characteristics are desired. Traditionally, farmers produce and sell their farm output in an open market consisting of local and regional buyers who serve as the entry point for food into the retail and wholesale distribution network. This system provides the producer with considerable independence, but also substantial risk. The quantity and quality of a farmer's output, which determines the income for the crop, is dependent on a host of factors, in-

cluding not only the farmer's efforts, decisions and practices, but also on elements beyond a producer's control, such as weather. Under this system, buyers of produce are unsure of the quantity and quality they will be able to purchase and at what price. In the end, in addition to considerable uncertainty and risk on both sides, traditional market sales also result in produce reaching the market with variation in quality, size, shape, and quantity. Contracting is seen as a means for farmers to reduce price and production risk and for buyers to reduce supply and quality uncertainties and to signal to growers more directly the quality and quantity that they want.

Agriculture has moved toward contracting steadily since the 1960s, with some contract production (mostly market vegetables for grocery chains) dating back to the 1900s. Sharecropping, a contract agreement to farm a parcel of land owned by another for a percentage of the produce, dates back even further. The advent of large-scale grocery store chains and their need to provide consistent product streams across a variety of markets accelerated this trend in the post-World War II era. Contracts became widespread in poultry production in the 1950s, and for cattle

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and hogs by the late 1960s. In their desire to provide consumers with consistent products, grocery chains and wholesalers have pushed for predictable quantity and quality from producers, and have often used contract production to achieve this. Today, contracting accounts for nearly one-third of the total value of production on U.S. farms. In terms of the number of farms involved, only 6 percent of all farms used contracts in 1969 to raise 12 percent of the total value of agricultural production. By 1998, 11 percent of all farms used contracts to raise 35 percent of the total value of agricultural production.

The increasing market share prepared foods hold in the national grocery cart has increased the specialization of the food processing, distribution and marketing industry. This, in turn, has caused contract agriculture to become more prevalent. Commodities heavily invested in these contract arrangements include broilers, hogs, dairy, eggs, peanuts, tomatoes, sugar cane and

beets, and fruit for processing. While contracting has been used by cigar and chewing tobacco manufacturers, cigarette companies only last year began direct purchases of burley and flue-cured tobacco, a quantum shift in marketing that has caused a stir unlike any other since the inception of the federal tobacco program in the 1930s.

Table 1 shows the relative prevalence of contracting for selected commodities in the United States in 1998. As Table 1 indicates, nine commodity groups (corn, soybeans, cotton, vegetables, fruits, cattle, hogs, dairy, and poultry) accounted for more than 90 percent of all contract production that year. Rice, peanuts, and cotton, although not representing significant segments of the total amount of contracted agriculture in the United States, presented a considerable share of production through contracts. Thus, while peanut contracts accounted for less than 2 percent of the total value of contracted agriculture in 1993, nearly two-thirds of the peanut crop was contracted, a level of contract saturation surpassed only by poultry.

Contracting Share of Production 1998		
Commodity	Share of total contract production (%)	Share produced under contract (%)
Corn	3.7	13.1
Soybeans	3.2	12.2
Cotton	3.0	50.6
Vegetables	7.5	45.4
Fruit	8.7	56.7
Cattle	11.7	25.3
Hogs	5.5	42.9
Dairy	22.7	54.8
Poultry	24.3	94.9
Peanuts*	1.8	64.6
Rice*	.4	19.6
All other commodities	9.7	14.4
All commodities	100.0	35.0

Types of Contracts

Generally, there are two kinds of agricultural contracts: marketing contracts and production contracts. Marketing contracts establish a pricing mechanism, usually a set price for established quality grades, and delivery procedures for a commodity. The producer makes most, if not all, management decisions and owns the commodity until marketing, thus bearing all the risk. Most contracted production in the United States is under marketing contracts. Crops commonly raised under marketing contracts include grain, cotton, peanuts, vegetables, and sugar beets.

Production contracts shift much of the management authority from the grower to the purchaser, usually a processing company. In a production contract, growers are required to abide by production conditions stipulated in their contract and may be supplied with inputs by the buyer (or contractor), provided technical guidance for production or given other forms of support. At marketing, producers are paid according to a pricing mechanism similar to one under a marketing contract, with inputs and contractor-borne costs removed. The buyer assumes some of the risk in a production contract, and usually retains ownership of the contracted crop or animal throughout,

Source: USDA, Farm Costs and Returns Survey, 1998, as quoted in *Rural Conditions and Trends Contracting Changes How Farms Do Business*, 2000; USDA, Farm Costs and Returns Survey, 1993, as quoted in *Farmers' Use of Marketing and Production Contracts*, USDA, 1996.

*1993 data not included in the 1998 survey.

generally retaining a larger share of the profits. Growers are restricted from marketing the product outside of the contract. Production contracts are predominant in hog, cattle and poultry production. Slightly more than one-third of the contracted value produced is done under production contracts.

Within these two general kinds of contracts, there is a third form of contract that blends some of the production independence with limited management or quality requirements. Depending on the commodity, a "blended" contract can involve shared risks and ownership of the commodity, with growers sharing in added value for premium marketing of higher grades or quality of output. This kind of contract is best suited to situations in which growers' actions can have major impacts on the quality of the final product, but the marketing company is not in a position to monitor or manage growers' actions.

In agriculture, contracting can offer benefits to both parties. Contracts are essentially risk management tools and, depending on the type and nature of the contract, are able to mitigate a producer's marketing and production risks to varying degrees by identifying the market outlet prior to planting and guaranteeing access to improved varieties, technical support, and proprietary inputs. In addition, contracts can offer producers protection from financial risk, since they guarantee a cash flow while possibly reducing overall capital needs, and may also provide access to new sources of capital. Many lenders require contracts as a condition for loans, and some contractors provide financing as part of their packages to producers. Contract growers often have access to technical assistance and new technologies that may only be available through such agreements. Contracts can also offer growers their only viable marketing option, as is the case for poultry and, increasingly, hogs. Finally, contracting can offer growers access to markets and higher prices for adopting prescribed production practices. Contracting provides a guaranteed market and assures a producer of a predictable sale at the end of the season, often at a pre-determined price.

Agricultural processing companies use contracts for a variety of reasons. Through di-

rect agreements with producers, these companies gain control over production practices, input use, genetics, and handling, leading to greater product uniformity and consistent quality. Contract production also allows companies greater control over product supply, ensuring that an adequate amount is available at appropriate times and minimizing price fluctuations due to inconsistent market volume. Contracts further allow companies to retain control over the use of genetic innovations and other patent-protected technologies. Contracts provide for greater protection for crops raised with specific characteristics, such as high-oil seeds. Companies also rely on contracts to lower risks and raise profits by entering into the production process without having to invest in land or facilities, and allows the expansion of corporate control of production into states where corporate ownership or operation of farm enterprises is prohibited or restricted.

Contracts also involve trade-offs for producers. In exchange for increased access to capital and markets and reduced risks, contract producers relinquish some independence. While most pronounced with production contracts, both forms of contracting involve a degree of outside involvement in decisions pertaining to the operation and management of the contracted crop. Another trade-off is that contract producers may be exposed to higher production costs, lower yields, production attrition due to partial rejection of a crop for quality considerations, and major investments in special buildings or equipment. This final consideration can be particularly problematic if investments must be financed for periods extending beyond the terms of the contract. There also are risks of not being paid or having lengthy delays before a contract is settled. In addition, contracts often involve complicated procedures for resolving disputes over payment or delivery. Under most traditional marketing systems, producers have clear recourse to the courts should a buyer dispute payment. With contracts involving premiums for quality or discounts or disqualifications for substandard goods, the contractor generally has extensive discretion in how strictly quality controls are applied. While usually not prohibited in contract agreements, resolution of disputes over these matters through the courts is costly and difficult.

Contracting in Other Sectors of Agriculture

As noted, certain sectors of the agricultural economy have had greater contract saturation than others. Most often, contracting is adopted in commodities in which there is little price risk protection or exceptional variation in quality factors due to producer effort and action. Broilers, hogs and eggs are possibly the most heavily contracted commodities, and are almost exclusively marketed through production contracts. In essence, under a production contract, a grower is raising an animal or plant "owned" by another party, following the owner's directions and using many of the owner's inputs. These contracts generally stipulate the various inputs and management activities to be used and separately account for grower compensation.

Integrators, who are the processors of the final products, provide the animals, feed, medicines and technical support for growers. Growers provide the land, barns or houses, labor, electricity and water, and the management of manure and dead animals. Growers are expected to comply with the integrator's production schedule and practices. Because integrators share risk and control production practices in these kinds of arrangements, they tend to dominate the terms of the contract as well. Most production contracts involve vertical integration, with the integrating firm owning or having significant interests in the companies supplying the inputs—hatcheries, feed mills and processing plants—connected to the contract. The integrator controls production rates through the management of restocking rates, both quantity and times. Integrators also stipulate the construction of animal housing and may indicate how manure and by-products are to be disposed.

Payment for production contracts generally provides for a fixed price per pound or piece with an adjustment up or down for performance. This can be measured by a feed-conversion ratio, or by a formula adjusting for input costs against total production and comparing production values with other producers within a set time window. Both adjustment methods are intended to encourage positive production practices.

Marketing contracts provide growers greater control of production, although processors still can exercise some controls over the qual-

ity and characteristics of the produced goods. Contracting companies may offer significant rewards for higher performance or discounts for poor performance, as measured against a set standard or prevailing conditions. Since there are a range of actions growers can take to affect quality, they are able to weigh the rewards offered against the added costs and labor required to achieve these benchmarks. How aggressively growers pursue top grades also may be affected by their perception of how other, uncontrollable factors—soil quality, anticipated bad or good weather—will play out in the growing season. Like production contracts, marketing contracts may stipulate the kinds of production practices the grower is to use, but the grower maintains ownership and bears greater risks. The production requirements under these contracts can extend so far as to specify approved varieties, chemicals, harvest procedures and more. Because growers assume great risks under these contracts and accept limitations on their decision-making, the payment structure typically includes a base value and rewards adequate to induce top performance.

Contracts in Tobacco

For many parts of the rest of the tobacco-growing world, contract production is the preferred marketing method. This is especially true in Brazil, Mexico, and Argentina (although not Zimbabwe, home to the world's largest tobacco auction). Worldwide, 81 percent of flue-cured and 54 percent of burley tobacco are grown under some kind of contract. In many other countries, the absence of a history of tobacco cultivation, limited extension resources, and a lack of available credit and inputs for producers have led to the establishment of production contracts for tobacco. Companies often provide seeds, fertilizer, pesticides, and technical support as well as facilitating access to credit. In the absence of alternative risk management tools in much of the rest of the world, contracting provides a manner of income security provided to American growers through the federal price support program.

In the United States, direct, but not contract, sales of tobacco to manufacturers have been common for chewing and cigar tobacco for decades, but rare for burley and flue-cured varieties. Tobacco destined for use in chewing tobacco, snuff, and cigars is a relatively small segment of the U.S. tobacco market with relatively few buy-

ers. In some instances, distances to markets are prohibitive for farmers, making direct marketing desirable. Nonetheless, the existence of a public market for these tobacco varieties and their inclusion in the federal price support program have made such "barn-door" sales a secure marketing option. Contracts are well established for growers of organic tobacco who sell to specialty cigarette manufacturers. Makers of specialty tobacco products, particularly organic cigarettes, often have specific cultural and production requirements that are beyond the capacity of the auction system to supply. Growers contracting for these products receive price premiums for their tobacco, although their production still must fall within the quota system.

When Philip Morris, the largest buyer of American leaf, made its announcement in 1999 and initiated a pilot project in 2000 to contract with Kentucky and Tennessee burley growers, the nature of the U.S. tobacco market was dramatically altered. The Philip Morris pilot program was designed to operate within the federal tobacco program, with each grower allowed to contract only that amount of tobacco for which they had quota. Within these production controls, however, Philip Morris sought to rearrange its buying patterns in one season. Philip Morris' continued reliance on the auction system in the 2000 season, and its stated intention to buy at auction in 2001, limits only slightly the ramifications of its decision to purchase large volumes of tobacco directly from growers. In essence, because of the amount of tobacco the company buys every year, once Philip Morris decided to contract, it became necessary for other tobacco companies and leaf dealers to follow suit.

According to the Philip Morris representatives, the principal reason for establishing contract relationships was a need for supply security. Specifically, Philip Morris expressed concern that it was having increasing difficulty purchasing sufficient quantities of the specific grades of tobacco it requires to make its cigarettes through the traditional marketing system. The

system for grading and auctioning tobacco also does not meet the differential values of quality grades it desires.* Furthermore, swelling stocks of largely low-grade tobacco in the stabilization pool had long concerned the industry. As stabilization pools increase, they have the effect of reducing the available quota and thus the amount of high quality tobacco that can come to auction. When the United States Department of Agriculture (USDA) announced a 45-percent cut in burley tobacco quota, Philip Morris, the largest purchaser of domestic burley, decided that it could not accept the risks associated with such a limited pool of tobacco (the effective quota in 2000 was 361 million pounds).

The intersection of a quota crunch and the tobacco industry's long-simmering dissatisfaction with the federal grading system were compounded by other factors. Among these, a basic realignment in the way the companies want to acquire leaf tobacco in order to improve efficiencies was perhaps the most significant. Also a likely factor contributing to the shift to contracting was the 1998 landmark settlement between the five major tobacco companies and 46 states' attorneys general, which placed additional financial pressure on the industry to limit expenses and improve control over supply. Furthermore, the possibility of regulation by the U.S. Food and Drug Administration motivated the industry to establish avenues that allow them to prescribe harm reduction practices, including improved genetics and cultivation and specialized curing processes to growers. Along these lines, contracting gives the industry better monitoring of production practices that could introduce prohibited or undesirable chemicals into tobacco leaf. Furthermore, the adoption of technological innovations, most specifically new curing techniques, can be accelerated through contract production.

Quality in tobacco is affected by a number of factors, including weather, soil, disease, plant quality, irrigation, pests, harvesting, curing, and farm management. All tobacco plants yield a range of grades of tobacco, from the lower qual-

* The stabilization pool is composed of all tobacco that is transferred from growers to the commodity co-operative under the price support system. If growers are not offered a bid on a particular lot of tobacco that meets price support levels, they have the option of surrendering the lot to the co-operative (stabilization) board for the price support level. The stabilization board pays growers with loans from the Commodity Credit Corporation, and later resells the lots in order to recoup the loan plus interest.

Making the Grade: a Short Course on Tobacco Grading

Under the federal tobacco program, USDA tobacco graders assess the quality of leaf to be sold at auction, assigning a federal grade to a given lot of tobacco. Graders consider specific physical characteristics, including body, color and the position of the leaf on the plant's stalk, in assigning grades. Split among five stalk positions, burley tobacco has over 130 tobacco grades; flue-cured has 109 grades among five stalk positions. The grades were established by the USDA's Agricultural Marketing Service (AMS) in 1935 as part of its market reporting purview. Inspectors from the USDA examine each lot of tobacco on the warehouse floor prior to sale and assign it a grade. Together, the grading system and the AMS's daily market news service provide growers with market signals that help them determine whether to sell, reject a bid, or place the tobacco in the stabilization pool. The grade also determines the price support level for the lot should it be surrendered into a stabilization pool, as the holdings of the cooperative tobacco board is called.

Because different parts of the tobacco plant yield differences in aroma, flavor, and strength, tobacco companies rely on the sorting of leaf types and positions to arrive at the optimal blend for their customers. In order to understand the different grades within the USDA system, it is best to separate tobacco first by its stalk position and then by color and quality. From the bottom of the plant, the five stalk positions and their USDA position designation letter (in parentheses) for burley are:

- ▶ Flyings (X): The lowest leaves on the stalk; generally flat, open-faced and relatively thin, showing the greatest amount of injury and duress.
- ▶ Lugs or Cutters (C): A group of mid-stalk leaves; thin-to-medium-bodied with a tendency to roll, and are broad in comparison to their length.
- ▶ Leaf (B): Leaves grown above the middle of the stalk; medium-to-heavy-bodied with a tendency to fold and are narrower in comparison to their length.
- ▶ Tips (T): Leaves grown at the top of the stalk; relatively narrow and pointed, generally less than 16 inches long, with less maturity than the leaf (B) group.
- ▶ Mixed (M) and Nondescript (N): These two groups, categorized together, consist of leaf that does not indicate a particular stalk position. The M group is made up of tobacco from across stalk positions. The N group is generally extremely low-quality tobacco that does not meet minimum quality tolerances of any group.
- ▶ For flue-cured tobacco, the groupings are slightly different. While flyings, lugs and leaf remain, the tips (T) group in flue-cured is called primings (P) because of the manner in which these leaves are harvested as they ripen.

Tobacco is further divided by color, which indicates the maturity or ripeness of the leaf. Color variations add 13 sub-groupings. The quality of a lot of tobacco is assigned a numeric value from 1-5, according to its maturity, ripeness, color intensity and hue, percent injury, uniformity, and leaf body. These attributes affect the grades of the various stalk position differently. Other factors that can weigh in on a tobacco's overall grade are moisture, damage, and abnormal amounts of dirt or sand.

The Philip Morris grading scale used for contract production in burley eliminates the M and N group, since contracted tobacco must be separated by stalk position, and collapses the multiple color and quality grades within the remaining grades into four basic group grades, numbered 1-4. Thus the Philip Morris grading system reduces the existing 120+ incremental grades to 16 more differentiated grades. Other companies' grading scales would similarly simplify the grading process and provide for less variation between stalk positions. This simplified process differentiates between and among grades more than the incremental scale used by the USDA, and allows the company to distribute price premiums for higher grades and discounts for lower grade tobacco.

ity flyings and lugs to the higher quality leaf and tips or primings. A number of the determinants of tobacco quality are outside the control of the farmers. Those factors the farmer can control include the selection of seed varieties and transplants, application of fertilizers and pesticides, irrigation and, obviously, harvesting and curing. Furthermore, farmers may selectively harvest their tobacco to increase the quality of leaf they bring to market, increasing the amount of leaf, tips or primings and composting excess flyings or lugs. Since the tobacco industry is particularly interested in increasing the percentage of higher grade tobacco delivered to receiving stations, incentive pay for these grades is expected to offset the grower's associated costs. Contracts specify the percentage tolerances for each grade, providing both a target and some guidelines on how much of any particular grade of tobacco the company is willing to purchase.

The burley contracts offered by Philip Morris in the 2000 season were essentially marketing contracts with some limited production guidelines. Philip Morris established six receiving stations in Kentucky and two in Tennessee, to which farmers were to deliver their tobacco on a specified day. The tobacco was then weighed, graded, and tested for moisture content by company officials. Growers were paid according to a pre-announced price schedule for the amount in each grade. Company, rather than federal, graders were used in establishing the grades for the tobacco, and no federal grade was assigned. These graders were usually experienced buyers or graders who had been trained in the Philip Morris grading system. No-net cost and burley promotion fees were deducted, but grading and warehouse fees, which pay for federal grading and the stabilization costs, were not. Barring any disputes, farmers were paid the day they delivered their tobacco, a major advantage over the delay in payment associated with the auction system.

Farmers unhappy with the assessment of grades have the option of getting a second opinion from another on-site grader and, if still unsatisfied, of pulling their lot off the floor and delivering it to auction to sell. Purchases were on an all-or-nothing basis, with farmers required to reject the Philip Morris price on all of their

contracted tobacco if they disagreed with the offered price on any basket. This, in part, protects Philip Morris from growers rejecting the offered price on the highest grades of tobacco but accepting the price offered on lower grades. Partial rejection could have forced the company to purchase a disproportionate volume of high grade tobacco at auction. Growers also were required to contract their entire allotment to Philip Morris. Although growers signed a contract with the company, they were permitted to place their crop on the auction floor if they so chose.

The amount of tobacco sold via contract in the 2000 season was impressive. Philip Morris' pilot project enrolled 10,749 sellers who raised 87.1 million pounds of burley tobacco, almost 30 percent of the total poundage sold. Early estimates of the volume of contracted leaf were set at around 110 million pounds or more, with some projections indicating as much as half of all tobacco sold would be purchased through contracts. A combination of an exceptional season and high auction prices may have enticed many farmers who had contracted their tobacco to Philip Morris to put their tobacco on the auction floor, instead.

Throughout its discussion of contract purchases of tobacco, Philip Morris noted that it did not anticipate meeting all of its tobacco needs through contracting. Philip Morris did purchase a significant amount of burley through the auction market, and it is reasonable to conclude that it is in the interest of the industry to have direct marketing and auction sales co-exist for at least the near term. In a transition period, and probably for some time afterwards, cigarette manufacturers likely will find it necessary to have a pool of auction tobacco to fill out its leaf requirements.

Because it offers tobacco companies greater control over the quality and quantity of tobacco they purchase, contracting may prove, in the long-term, to be the marketing method it prefers for nearly all domestically-purchased tobacco. Companies that purchase tobacco specifically for export would likely be harmed by a total transition to contract production. Because these companies prize selectivity, contracting would potentially saddle them with quantities of

lower grade leaf that they may not be able to sell. The current auction market provides them with the opportunity to pick and choose among grades. Under a contracting regime, these companies likely would have to purchase all grades from a producer and then resell the unwanted portion of their purchases to domestic companies, possibly at a loss. Another possibility is that they would contract with a leaf dealer that contracts with farmers for all grades and then act as a clearing-house for tobacco. This latter option is common in many other tobacco-producing countries.

Flue-cured tobacco contracting came about in part due to a shift in technology for curing tobacco. In 1999, Star Scientific, a wholly owned subsidiary of Star Tobacco and Pharmaceuticals, began marketing StarCure tobacco, produced using a proprietary process that reduced the formation of carcinogenic toxins present in tobacco smoke, primarily tobacco-specific nitrosamines (TSNAs). Tobacco companies expressed an interest in this low-nitrosamine tobacco, and the USDA moved to have all flue-cured tobacco cured in this manner by June 2001.

Flue-cured tobacco is cured by hanging the green leaf in a barn and then heating the air in the curing barn. Before World War II, the heat source for most curing barns was a wood fire outside the barn, with the heat transferred to the tobacco through a flue that ran under the floor of the barn and then up through the curing barn. After World War II, most farmers switched to fuel oil as a heat source, but continued to utilize the flues that carried the heat through the barn. During the oil crisis in the 1970s, farmers began to switch to propane and natural gas heat. Because these fuels burn more cleanly, farmers also were able to dispense with the flues and began direct-firing tobacco. While easier and more efficient, direct-firing exposes tobacco to combustion gases, which contribute to the creation of TSNAs. Experiments in creating a low-nitrosamine burley variety have been frustrating, with Star Scientific scaling back its tests in 2001 after producing leaf in its 2000 trials that had below-par flavor.

In much of the rest of the world, the curing of flue-cured tobacco continues as it has since the process was first discovered in 1838. Because

of this, foreign leaf is lower in TSNAs and thus "safer" than American leaf. In an effort to reduce the harm to human health from smoking, tobacco companies have insisted that they will only purchase low-nitrosamine tobacco beginning in July 2001. This announcement, coming in late 1999, gave growers very little time to retrofit curing barns with heat exchangers to carry heated air through the barns while venting the combustion gases to the outside. The cost for installing these exchangers averages anywhere from \$3,000 to \$5,000 per barn. Since many growers have multiple barns, retrofitting barns can add considerable costs for growers at a time when tobacco revenues are declining.

In order to provide for a swift transition to low-nitrosamine tobacco and to ensure that farmers would be able to meet the USDA retrofit deadline, the flue-cured stabilization board and Philip Morris created a reimbursement fund for farmers totaling \$85 million. Additionally, Star Scientific, which purchases tobacco for Brown and Williamson, and RJ Reynolds offered farmers contracts with price premiums for low-nitrosamine tobacco, essentially a payment over time for an up-front investment. Interestingly, the stabilization board program was initiated in part to ward off contracting from flue-cured tobacco, providing farmers with assistance for barn conversion in order to protect producer independence. A major concern among growers with retrofitting barns is the stability of a market outside of contracting once they have made the investment in heat-exchanging equipment.

The RJ Reynolds and Star Scientific contracts tend to be multi-year agreements for the production of low-nitrosamine tobacco. More than 250 farmers, primarily in Virginia and North Carolina, contracted with Star Scientific in 2000. RJ Reynolds contracted with an unspecified number of farmers for almost all of their flue-cured needs in 2000. In all, 49.8 million pounds of flue-cured tobacco was marketed through non-auction sales, mostly direct contracts, in the 2000 season compared to 574.7 million pounds sold at auction. For the 2001 season, every major U.S. tobacco company has indicated an intention to purchase tobacco through contracts. RJ Reynolds has announced plans to purchase all of its burley and flue-cured tobacco through contracts. Philip

Morris and Brown and Williamson have announced intentions to buy tobacco both on contract and at auction, with Brown and Williamson relying on the auction system for more than half its tobacco needs. Lorillard intends to purchase contracted tobacco through Dimon Leaf, the Danville, Virginia, based company that is the second largest independent tobacco dealer in the world.

In the United States, tobacco contracts generally are marketing contracts, with some production requirements. They last anywhere from one to three years, and cover all of a grower's production across all stalk positions and grades. Contract production also is conducted within the current price support program, so all tobacco sold directly is deducted from a producer's marketing card, as it would be when sold at auction. Among the terms a typical contract may include are:

- ▶ Specifications on where and how the tobacco is to be delivered, generally including separation into bales of less than 100 pounds with a moisture content of less than a set amount (24 percent in most contracts);
- ▶ Provisions for the amount of tobacco to be contracted and allowances for substitution of current year crop with carryover tobacco;
- ▶ Definitions of prices for each grade;
- ▶ Requirements that contracted tobacco be stripped and separated into at least three stalk positions, maintaining normal grade distributions by stalk position;
- ▶ Descriptions of allowable seed varieties;
- ▶ Definitions of approved or prohibited cultural and agronomic practices, including the use of only government-approved chemicals applied in accordance with recommended procedures and regulations and restrictions on the use of chemical ripening agents;
- ▶ Restrictions on where contracted tobacco may be grown (generally, it must be grown on the contracted farm and cannot be leased out);
- ▶ Requirements for ownership of and clear title to the land to be used for production;
- ▶ Provisions for access to contracting growers' farms and requirements for record-keeping for review by a contracting company;
- ▶ Distributions of weight allowances for each specified stalk position by percentage;
- ▶ Provisions for dispute resolution;
- ▶ Prohibitions on the disclosure of contract terms;
- ▶ Procedures and schedules for grading and testing the tobacco;
- ▶ Expectations for a minimum number of harvests per season;
- ▶ Requirements to abide by applicable state and federal laws, e.g., Fair Labor Standards Act, Migrant and Seasonal Agricultural Workers Protection Act;
- ▶ Listings of any fees or payments to be made to or by either party; and
- ▶ Correlation between contract grades and USDA grades.

Because contracting in flue-cured tobacco will involve the conversion of curing barns to new technologies, contracts for this kind of tobacco will include requirements to sell only low-nitrosamine tobacco, and may outline which methods of curing this will entail.

Also as noted, contracting offered farmers higher prices for their tobacco than the auction market in 2000. In flue-cured tobacco, contracting farmers were selling a value-added product low-nitrosamine tobacco as well as avoiding some transaction costs. In burley, the increased sales price derived from a beneficial pricing schedule and the absence of warehouse and grading fees, amounting to a potential 5-cent to 7-cent advantage per pound. It has been observed that the federal price support system and the presence of an auction market create the price floor for tobacco contracts. In order to induce farmers to sell through contracts, the financial benefits and reduced risks of contracting have to outweigh the price potential on the open market. Indeed, the competition to lure farmers in to the auction market and the competition between flue-cured contracting companies to secure farmers has the effect of driving up the price of tobacco sold both at auction and through contracts.

The Trouble Overseas

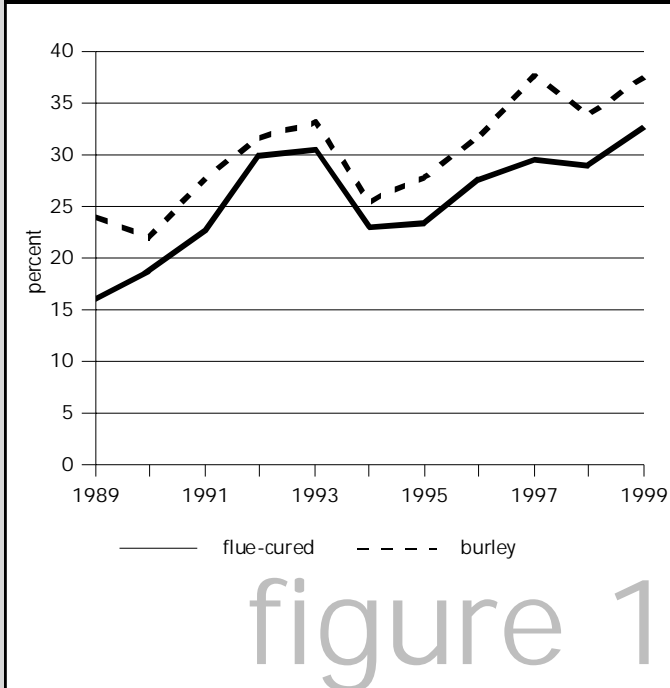
American tobacco is widely regarded as the finest in the world, and most manufacturers of premium cigarettes rely on some American leaf to add flavor, mellowness, and taste to their blends. American tobacco also is the most expensive in the world, due in no small part to the federal tobacco program. Up until the late 1990s, the United States also was the largest exporter of tobacco, a distinction now held by Brazil; the United States remains the world's leading exporter of cigarettes and the largest importer of tobacco. The world tobacco market has a handful of powerhouse exporters, including the United States, Brazil, Zimbabwe, and Malawi, with production increasing in a number of other countries as well. The globalization of tobacco weighs heavily on a discussion of contracting for a number of reasons. Contracting is a commonplace practice for tobacco production in many places outside the United States. Furthermore, export markets are vital to U.S. producers, particularly as domestic consumption drops. The displacement of U.S. tobacco with that of foreign origin in products manufactured domestically and elsewhere represents a considerable challenge to maintaining U.S. production levels. And, finally, the relocating of American-brand cigarette manufacturing offshore, closer to burgeoning foreign markets, generally signals a drop in the amount of U.S. tobacco in those blends.

China, the world's leader in overall tobacco production, is not a major player in either exports or imports of tobacco. Currently, China produces more than one-third of all tobacco grown globally, over 5.1 billion pounds, almost all of it for domestic consumption. China has an estimated 300 million smokers who consume an annual 1.7 trillion cigarettes. This amounts to more than two-and-one-half times the 720 billion cigarettes produced by the United States, 217 billion of which are exported (21 percent of the world's total trade in tobacco products). Up until a trade agreement was signed last year, legally-imported cigarettes were subject to a prohibitive tariff. It is still unclear how much U.S. and other foreign brands will penetrate the Chinese market, although there is a booming market already in place for smuggled American cigarettes in many of China's larger cities. There are not inconsiderable hopes that the Chinese market may prove to be an outlet for American leaf and tobacco, but the current prices of both products might serve to seriously restrict how much of a boost the opening of the vast Chinese market to American products will have. This hope is tempered, however, by the reality that U.S. cigarette exports, as a percentage of world trade, declined significantly in the 1990s, from over 26 percent at the beginning of the decade, to less than 21 percent at its close.

The decline in cost competitiveness of U.S. tobacco on the global market has had a depressive effect on exports and has encouraged the use of imported leaf in domestically-manufactured cigarettes. Foreign tobacco is a necessary component in most cigarettes. Almost all blends including some quantity of oriental leaf, which is grown primarily in Greece, Turkey and Macedonia, and is included in blended cigarettes for its aromatic qualities. But the percentage of burley and flue-cured tobacco of foreign origin in domestically-produced cigarettes is increasing. This figure has been rising steadily since the 1970s, when there was only a negligible amount of foreign burley of flue-cured tobacco in cigarettes. In 1999, the import share of total flue-cured tobacco used was 32.7 percent, up from 28.9 percent in 1998, and from 16.1 percent a decade before. The import share of burley tobacco used in 1999 was 37.5 percent, up from 33.7 percent the previous year and 23.9 percent in 1989. Figure 1 illustrates the trend in imported tobacco use in manufactured products.

Obviously, a rise in imported leaf would indicate a drop in domestic leaf in domestically-manufactured cigarettes. In the 1960s, virtually all of the burley and flue-cured tobacco used to manufacture cigarettes in the United States was of domestic origin. By the late 1990s, the amount of foreign tobacco in American-manufactured cigarettes was approaching 50 percent. U.S. tobacco is protected under a tariff rate quota (TRQ), which sets a zero tariff for the first 333 million pounds for the 2001 season, and then imposes a 350 percent ad valorem import duty on any tobacco above that limit. There is, however, a drawback allowance if the imported leaf is later re-exported as leaf or

Import Share of Domestically-Manufactured Tobacco Products



Source: USDA/Economic Research Service, Tobacco Situation and Outlook, September 2000.

77 percent of all burley tobacco, and 55 percent and 51 percent, respectively, of the total global trade volume. By 1998, the U.S. share of production had dropped to 9 percent for flue-cured and 27 percent for burley, and the U.S. share of trade was down to 14 percent and 18 percent, respectively. At the same time, global tobacco production has swelled. In the late 1950s, world tobacco production, including the United States, was almost 8.9 billion pounds. In 1997, world production had increased 87 percent to over 16.6 billion pounds.

American cigarette brands are among the most valuable in the world, with global identification unmatched by almost any product. Marlboro and Camel cigarettes have almost unmatched brand recognition globally, making these cigarettes in particular very easy to introduce to new markets. For American cigarette manufacturers, this has allowed them to expand sales internationally while domestic consumption drops. As the industry looks to its future, the most lucrative markets are outside the United States, particularly in Asia and Latin America. In order to better capitalize on these growing markets, and to realize lower costs of production, American-brand cigarettes for foreign markets are increasingly being manufactured outside of the United States. While the tobacco industry stresses that it strives to maintain a uniform product regardless of where it is produced, this does not mean that a cigarette contains the same mix of tobaccos everywhere. Indeed, it is more likely than not that cigarettes manufactured "offshore," while packaged in similar wrappers to their American cousins, will include significantly less American tobacco, if they include any at all. Thus, the shift in production for foreign markets has an impact on domestic purchasing intentions, which affects both domestic production quota, and, indirectly, the long-term transition to contract production.

manufactured product. In place since 1995, the duties under the TRQ are seldom fully recovered due to the tremendous volume of cigarettes exported by the United States.

The rise in imported leaf in American cigarettes is partly due to cost, but also reflects other factors. Among these are the improving quality of foreign tobacco and increasing emphasis on trade in tobacco by a number of countries, including Brazil, where tobacco has only been grown since the 1970s. Foreign cigarette makers also have been paring back their purchases of U.S. tobacco over time, contributing to the quota crunch that affected growers over the past four years. The increased availability of tobacco on the global market has made for a much more competitive market for U.S. producers. In the 1950s and 1960s, the United States produced about 40 percent of all flue-cured and

Controversy over Contracts

Contract agriculture is well-established in many commodity markets and is gaining market share in others, including tobacco. There is considerable controversy surrounding direct marketing relationships for several reasons. The most commonly cited concern over contract agriculture is the relative power of the parties involved. In the presence of an open market, farmers who do not like the terms of a contract can take their output and sell to willing buyers through a market arrangement. Consolidation and concentration in a number of sectors within agriculture, including grain handlers, slaughterhouses, dairy consolidators, and grocery wholesalers have reduced the openness of markets for these commodities in some regions. In the absence of open markets, critics maintain that integrators and other contract buyers have disproportionate influence in determining contract terms, prices and conditions, and can penalize growers who object to contract terms.

These complaints are most often lodged against production contracts, in which a grower's independence is often very limited. Poultry and hog farmers have brought their concerns to legislators at the state and federal level. This has resulted in proposals to, among other things, overhaul the Packers and Stockyards Act, which regulates marketing practices in the livestock, meat and poultry industries; to create producer protection legislation; and to reform existing antitrust and corporate farming regulations. To date, this activity has not resulted in any significant changes at the federal level, but the related issues of concentration in industrial agriculture and the relative market power of producers and integrators is under more scrutiny now than at any time since the Packers and Stockyards Act was passed in the 1921.

The growth of contract production has taken place at a time when there has been remarkable concentration in many of the sectors in which contracting has increased the fastest. The collision of these trends has created a deep sense of concern across much of agriculture that the open market farmers historically have enjoyed for their goods is swiftly being replaced by a vertically-integrated production system in which on-farm producers are merely managers or employees of

a distant company. The leverage a given agribusiness entity might have in a commodity market often is heavily determined by the alternatives producers have to sell to other buyers. As outlets in a market become consolidated, the market closes, and producers often are at a disadvantage in negotiating terms of sale for their commodity. Tobacco, a sector that is already heavily concentrated, has for years had a supply control and price support program that has given producers an edge in price negotiations, even in the presence of limited competition. Tobacco production also benefits from a limited geographic range. Because tobacco production is currently conducted in a geographically compact area, all competing tobacco companies are able to operate in almost every market, providing competition and alternative outlets for producers.

How this situation will change under widespread tobacco contracting is hard to predict. In response to concerns over contracting in poultry, hogs, and tobacco, a number of state legislatures have introduced legislation to provide some protections to producers engaged in contract agriculture. Although largely driven by production contracts, model legislation developed by the Iowa attorney general's office includes a number of proposals being sought by tobacco growers' groups. Among them are:

- ▶ Requirements that contracts be written in plain English and clearly disclose risks;
- ▶ Provisions for a cooling-off period and a right to review contracts with outside counsel;
- ▶ Prohibitions against confidentiality of terms;
- ▶ Protections from early terminations of contracts; and
- ▶ Protections for growers who participate in producer associations or other groups.

Other contracting-related proposals include requiring mediation clauses in contracts and joint and severable liability for contracts of subsidiaries, tying parent companies to a subsidiary's contracts. Such "producer protection act" have the endorsement of attorneys general from 16 states as well as support from members of Congress. To date, the only tobacco state that has adopted any contracting legislation of this nature is Georgia, which passed HB1245 during the 2000 session. In part, the legislation provides growers the right to have contracts reviewed by outside

counsel prior to execution, requires tobacco contracts to be written in plain English, and allows for a three-day "cooling-off" period.

Other producer concerns with contracting include the negative effects contracts can have on non-contracting farmers and on small farmers who may have more difficulty securing contracts. Furthermore, contracts usually have the effect of reducing the amount of market information disclosed to the public. Many contracts include clauses prohibiting disclosure of price or sale terms, and those figures that are reported often do not adjust for required input and capital costs. Finally, both producer and consumer groups have been vocal about the potential for the abuse of market power by contracting firms.

Possible Impacts of Contracting in Tobacco

End of the federal program

There are a number of unanswered questions about the impacts of contracting in tobacco. Possibly the most important is the fate of the federal tobacco program. As more tobacco shifts to contracting, the future of the federal tobacco program is brought into question. Flue-cured and burley quota holders voted to continue tobacco quotas for the 2001 through 2003 seasons, which would seem to protect the program at least that far. However, there are several variables that threaten the price support and production controls that have served American growers since the 1930s. Threats to the tobacco program are not new, but the momentum to eliminate government intervention in markets, the recent volatility of quotas, and the status of global tobacco trade make the program more tenuous than ever before. Most observers agree that the elimination of the program would have the effect of increasing tobacco production in the United States, dropping the price for manufacturers and exporters (although not necessarily for consumers), consolidating tobacco farms and reducing the number of tobacco farmers dramatically.

Additionally, there is the possibility that grading fees may not cover the costs of the system (since fees are established prior to the opening of the season), causing the grading system to fold. Since the program is dependent on the

shared costs of the grading system, as the number of producers paying for the grading system decrease, the per-grower costs rise. At some point, warehouse and grading fees could rise above a tolerable threshold, and growers would be at too great a price disadvantage to continue to pay them. Within a season in which there were insufficient grading fees collected to cover the cost of the system due to an unanticipated shift to contracting, there is a very real possibility that the system could essentially stop operating due to a lack of funds.

Should this come to pass, production controls would remain in place, but no price support could be offered because there would not be a federal grade attached to the tobacco. Any leaf placed in stabilization lacking a grade could have no price guarantee, and the stabilization pool could amount to little more than a consignment service. Furthermore, growers with contracts who are guaranteed a market and a price may perceive the federal program as limiting their income by restricting their production. Thus, in future referenda, the program potentially could be at risk. In reality, since the tobacco firms have to meet or exceed the loan rate (support price) for tobacco, the program sets the floor for the program. Absent this floor, tobacco prices could slip in the face of buyer pressure and competition from foreign leaf.

One of the additional complications that could arise with widespread contract production is a drop in the amount of publicly-reported market information. Public sales disclosure was a keystone piece of the regulation of tobacco markets in the 1930s. Under the current program, the USDA releases daily market news reports of sales volumes and prices, as well as information on loan stocks and transfers into stabilization pools. Farmers can use this information in making decisions on marketing their crop and bids they receive for their tobacco at auction. In the absence of this information, farmers will have no measure for judging whether the price they are offered for their tobacco is reasonable, and contract growers have no signals as to whether their contract prices are superior to those on the market. In the absence of an auction system in which all farmers sell directly, the lack of market reporting

places growers at a disadvantage in assessing the comparative value of their produce and makes it difficult for regulators to determine if marketing firms are abusing their market strength.

While the tobacco industry has committed its support to the tobacco program for as long as tobacco growers continue to endorse it in grower referendums, contracting in the end could undermine the program's effectiveness for growers. The federal program is not without its perils, however. Chief among these is its tendency to make domestic tobacco more expensive, and thus less competitive, than foreign tobacco. Furthermore, with the federal program as it stands, the benefits of increases in prices paid for tobacco under either marketing structure accrue to quota holders. Often, quota holders are not the individuals producing the tobacco, either leasing out part of all of their allotment or farming with partners on a share basis. Generally, when tobacco prices rise, so does the value of tobacco quota. Thus, leasing growers, who must make the labor investment to produce a quality crop, may not witness a satisfactory return if quota rental costs consume the bulk of the added value of his crop. Furthermore, the net effect of American prices supported so far above the global market price, in addition to increasing lease prices for growers—essentially a transfer of the benefit of contracting from grower to quota holder—is a further erosion of the price competitiveness of U.S. leaf in the export market.

Changes for auctions and warehouses

This raises the question of the critical mass of tobacco that must go through the auction system in order to keep it functioning. While growers do not have to designate their marketing outlet until August, early indications point to considerable saturation of contracting in all burley and flue-cured markets. Representatives of auction warehouses speculate that the amount of contracted tobacco could be as much as 65 percent or more of burley and as much as 80 percent of flue-cured. The number of warehouses has been declining along with quota over the past few years, and the diversion of tobacco from the auction market to direct sales is anticipated to accelerate this trend for the 2001 season. It is anticipated that no auction houses will open in Florida in 2001, down from four that opened in 2000. South

Carolina likely will only have three or four open in 2001, a sizable reduction from the 20 that opened in 2000. Significantly, Florida and South Carolina are states with larger-than-average tobacco acreage per grower and higher yields per acre than average, making contracting very attractive in these regions.

If the federal tobacco program is to survive, an open market system must exist in order to provide an outlet for non-contract tobacco. If contracting expands as anticipated, the nature of the auction system may change radically. Most contracts provide growers the option of rejecting the company grade and selling their tobacco at auction without restriction. To date, no partial rejections have been allowed, thus a farmer's entire production across all grades would enter the auction system. Tobacco companies should seek to reject as little tobacco as possible in order to capture maximum contracted volume and thus reduce the amount they must buy on the auction market. Thus, rejected tobacco likely will be either of exceptionally high quality, since a grower might conclude it would fetch a higher price at market or, more likely, of low quality. The complication then rises that the auction market may become flooded with low-grade tobacco. This, in turn, leads to a number of problems. First, if auction houses become the point of sales for low-quality tobacco, it is likely that fewer buyers will use this outlet. Second, if auction sales are predominantly low-grade tobacco, prices paid at auction will drop, and more tobacco will likely enter the stabilization pools. The issue of Philip Morris' ability to buy tobacco from stabilization pools that met their needs arose in its initial announcement of direct contracting. If even more low-grade tobacco enters the pool, existing stocks will rise with little hope for recoupment or disbursement. Swelling stabilization stocks also would cause further quota cuts.

There is concern that the fringe areas of production may no longer be viable as tobacco markets. The number of flue-cured auction houses has declined slightly over the past few years, with the notable exception of North Carolina, where 28 percent of the auction houses operating in 1997 have closed. More telling, however, is the drop in the number of sales days these houses are holding. As the deadline for market designation ap-

proaches and producers must identify where they will market their tobacco, both burley and flue-cured warehouse associations are anticipating a number of warehouses that will not open in the 2001 season, even in the heart of tobacco-producing areas. Since contracting utilizes relatively fewer receiving stations than an auction system did of warehouses, there will be a net loss in tobacco-marketing facilities. Some well-located warehouses will become receiving stations for tobacco contractors, but other warehouses will simply close. This is a part of the efficiency gain of the contracting system, but for rural communities, it can represent a significant loss. When a warehouse closes, the community suffers the loss of both permanent and seasonal employment, residual business sales, and gains a large, permanent building with few potential alternative uses without expensive conversion costs. Furthermore, as warehouses close, there will be an anticipated geographic concentration of auction houses in high volume markets in the upcoming seasons, adding to the transportation costs for producers and further eroding the value of tobacco sold at auction.

Who gets to play?

Both for growers and buyers, contracts usually are most efficient for larger producers. In its pilot year, Philip Morris signed contracts with growers of all sizes, with agreements ranging in size from fewer than 100 pounds to more than 100,000 pounds. Nearly half the agreements the company signed were with farmers who grow fewer than 5,000 pounds. Philip Morris' contract distribution reflects the distribution of burley growers fairly well. In other commodities, however, contracting tends to be more common among larger producers. Larger producers tend to have the ability to meet rigid and sometimes expensive contract management requirements. Furthermore, contracting companies can reduce the total number of contracts and associated costs and uncertainties by forging arrangements with fewer large operators.

There are few truly huge tobacco operations, so the short-term potential for production concentration is limited, particularly within the framework of the quota system. In the long-run, with or without a program, larger farmers likely will be better situated to take advantage of the

benefits of contracting. Furthermore, farmers with large amounts of tobacco to market may find the price and market security of contracts more attractive than farmers with smaller quota, and thus will be disproportionately represented in contracting.

If contracting becomes the exclusive avenue for high-value sales, demand for contracts may exceed the number extended by tobacco companies. In this situation, willing growers would be frozen out of the contract market, and thus potentially out of the market altogether should the auction system vanish or prove inaccessible. In a situation where the demand for contracts exceeds the number that are offered, other sectors of agriculture have had negative experiences with growers having their contracts revoked or not renewed to penalize growers who have been critical of the integrator. In the current tobacco environment this seems unlikely, but it is a concern voiced by growers throughout the tobacco region.

An additional possibility is the geographic spread of tobacco production in the absence of a tobacco program. While unlikely in the short run due to the concentration of existing experienced growers, receiving stations, and manufacturing facilities in the tobacco belt, there are few agronomic limitations to growing tobacco elsewhere. Should the federal program be discontinued, the advantage of growing tobacco on larger parcels of land or on a different harvest cycle may offer incentives for the introduction of new tobacco acreage outside the historical range of cultivation. It is particularly likely that in a vertically-integrated production system tobacco companies may choose to cultivate, either through contracts, subsidiaries or directly, large acreages near export centers for growth markets, particularly in the western United States.

Another geographic concern related to contracting is the possibility that contracting will concentrate around receiving stations, leaving contract producers in distant areas unable to compete with proximate growers, or potentially unable to secure contracts at all. In Missouri, where growers faced this challenge in the 2000 season, a local warehouse served as a collection point for transshipment of tobacco to the nearest receiving

station. The added costs and risks associated with this were borne by the producers. In the future, warehouses not affiliated with contracting companies could serve as cooperative collection points for growers, but companies would have to agree to accept leaf from growers who are not on site. Such arrangements also pose significant challenges for dispute resolution processes and grade acceptance, since the involved grower would not be present to pursue second grading opinions and dispute follow-up procedures.

A thorny issue for many growers is the extent to which contracting companies will dictate management decisions, cultivation practices or technological innovations. Contracts for flue-cured tobacco already stipulate the installation of heat exchangers in barns to produce a low-nitrosamine tobacco. As research continues, farmers are worried that new cultivation, harvesting or curing techniques could require them to make large capital investments that would essentially lock them into company contracts. If future contracts were to require additional investment, growers would look to contracting companies for financial assistance for their implementation, as RJ Reynolds and Star Scientific provided with their low-nitrosamine contracts.

A sign of what's to come?

Tobacco production in much of the rest of the world is conducted through contracts. Unlike contract production in the United States, however, these agreements tend to be production contracts with considerable control exercised by the buyer. This is necessary in these markets for several reasons, including limited technical extension support and access to capital. In the United States, which is free from such limitations, production contracts are still not a considerable factor in tobacco, and the tobacco industry has

emphasized their commitment to grower independence. Since the principal reason for instituting contract arrangements is to control the quality and quantity of leaf that they buy, there are some obvious advantages in inserting production measures into contracts. Production measures currently are components only for tobacco grown organically and for genetically-modified tobacco. Requirements to separate leaf by stalk position and restrictions on chemicals and varietal selection in current contracts are very different from mandates to use company-supplied seed and chemicals, on a timetable provided, and to allow for on-site inspection. Delivering and monitoring such a system involves a massive investment, both of capital and personnel, which the industry is unlikely to be interested in making domestically. Such a shift also would face cultural and social resistance from the grower community.


A major concern of growers is the possibility of vertical integration in the tobacco industry. Tobacco, while concentrated at the manufacturing level, actually is remarkably differentiated in structure. In the United States, growers, auction houses, wholesalers and retail outlets are by and large independent operators in an open and competitive market. There are concerns that the current wave of contracting eventually will lead to production contracts and vertical integration as tobacco companies strive to introduce more sophisticated, and possibly proprietary, harm-reduction measures, transgenic and other improved varieties, and special harvesting and curing procedures. Production contracts, which shift ownership of the tobacco in the ground at least partially to the purchaser, would be a significant step to ownership of every phase of the tobacco life-cycle, from seed to cigarette, by one company.

Conclusion

The 2001 tobacco season will be a watershed year for the crop, in which it likely will be determined whether a dual auction/contracting marketing system can survive. If tobacco contracting rates reach anticipated levels, the number of auction houses and sales days could be cut in half from the 2000 season, if not more. After years of quota cuts, growers and warehouses alike face a tenuous situation. The tobacco companies have become increasingly worried about their ability to secure the quality and quantity of tobacco they require for their products in a shrinking tobacco market. Contracting provides both growers and the tobacco industry an opportunity to share risks and increase efficiencies. Price and marketing risks in tobacco are, however, already mitigated by the presence of the federal price support program, which is itself threatened by the surge in contracting.

Given the advantages of having two healthy systems for at least a transition period, it would seem vital to provide growers, quota holders, tobacco warehouses and the tobacco industry with an adequate platform to conduct business. In order for this to happen, it seems necessary that there be some supplemental support for the federal grading system in order to protect its financial security, possibly by having all grading conducted by federal graders. Furthermore, a transparent and public market is in the best interest of all parties. If this is assured, contracting

need not lead to a net decline in marketing news or disclosure. Also, in order to minimize disputes, plain English contracts with the right to review by outside counsel and provisions for removal, as have already been implemented in Georgia, are advisable.

In the presence of adequate protections, American tobacco farmers likely will weather this turmoil and emerge financially sound and productive. The future of domestic tobacco production is dependent on more than the manner in which the leaf is marketed. Drops in domestic consumption, shifts in global cigarette production, and an increasingly competitive global market may have a greater impact on the long-term viability of tobacco production as it exists today in the United States. Small farmers producing a few thousand pounds a year may find their ability to market their crop profitably undercut by factors entirely outside the debate on contracting. In some respects, contracting, with appropriate protections for both parties, may provide the most secure, predictable route to a stable tobacco market for American growers. The unanswered questions about the impact contracting will have and the uncertainty over the future is little salve for the worries of growers who have been beset with problems outside their control in the past decade, however. Understanding the anxiety in tobacco country and providing support to farmers and quota holders in this time of transition should be of utmost priority. 

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