

Tobacco Issues: Contracting and Use of Tobacco Settlement Payments

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I have the privilege of talking with you today about some of the issues on the radar screens of tobacco growers and the tobacco industry. Keeping track of all of the moving targets on the already-full tobacco sector radar screen is about as confusing and overwhelming as grading tobacco seems to me.

Legal and Political Issues. Legal battles continue to rage against cigarette manufacturers with the fate of the \$145 billion Engle judgment in Florida still in limbo and more than 500 other lawsuits active. Also hanging in the legal balance is the suit against cigarette manufacturers filed by tobacco growers and quota holders, with more than 6,000 plaintiffs on board and motions to be heard in a matter of days. The impact of the change in administration is still an unknown, as the Department of Justice suit against manufacturers appears to have lost momentum, but FDA authority over manufactured tobacco products and action on the upcoming President's Tobacco Commission recommendations are still on the radar screen.

Program/Marketing Issues. There are a number of hot buttons related to the tobacco program and marketing of tobacco, not the least of which is the widespread growth of contracting. Growers and quota owners went into the most recent round of program continuation referenda still reeling from large quota cuts over the last few years and skyrocketing quota lease costs. Growing pressures on the auction warehouse system, renewed interest in a quota buyout and licensing/permit system, and quality issues related to pool stocks are all unresolved issues.

Production/Grower Issues. Contracting, of course, is a major grower concern and several tobacco states are considering legislation establishing minimum contract standards. Recent infusions of payments to tobacco growers and quota owners through the National Tobacco Growers' Settlement Trust (Phase II) and the Tobacco Loss Assistance Program (TLAP) are affecting production and leasing decisions. Most of the major tobacco-growing states are also using a portion of their tobacco Master Settlement Agreement payments for programs targeting agriculture and tobacco producers. While it is still primarily a flue-cured issue, curing processes that reduce tobacco-specific nitrosamines are bringing to light a number of questions about crop quality and the role of stabilization.

Trade Issues. Declining exports of U.S. leaf, coupled with increasing imports of foreign leaf are major concerns in the industry, as

is declining use of domestically produced leaf in U.S. cigarettes. Competitive pricing of U.S. leaf in international markets is an important issue. The trend toward increasing cigarette manufacturing capacity offshore is also a concern. The impact of the recent opening of China to tobacco trade remains to be determined.

Health and Product Issues. With domestic cigarette consumption declining, the impact of new products with lower tobacco-specific nitrosamines, reduced polycyclic aromatic hydrocarbon (PAH) compounds, considered by many in the health community to be the most severe carcinogenic in cigarettes, and the prospect of new low-nicotine products remains to be seen. A number of questions about potential FDA authority, such as whether the product to be regulated is a cigarette or a drug delivery device, are being hotly debated. Health concerns are taking a more global twist, as the World Health Organization Framework Convention on Tobacco proceeds. Additionally, new medicinal and biopharmaceutical uses for transgenic tobacco are drawing considerable interest.

Obviously, we can't even scratch the surface of many of these issues in our time here today. Several of these issues are being covered by other speakers who will discuss the tobacco program and international trade. What I want to do today is at least make you aware of some of these issues and discuss more in depth two issues important to tobacco growers. First, I'd like to cover some of the issues associated with the widespread and rapid increase in the use of contracting in tobacco marketing, especially the longer-run economic impacts. Second, I'd like to provide an update on the status of tobacco Master Settlement Agreement (MSA) payments to major tobacco states and also on the use of Phase II payments in major tobacco states, emphasizing the economic impacts of these payments on tobacco growers, quota owners, and agricultural communities.

Contracting

The idea of contracting U.S. tobacco is not a new one. Some specialty tobacco companies have a track record with contracting and smokeless tobacco types are often direct purchased. Some leaf dealers also purchase tobacco for export directly or through contracts with growers. Outside the U.S., marketing contracts, production contracts, and vertical integration are much more common for foreign-grown tobacco. USDA's Agricultural Marketing Service estimated

in 1998 that about 80% of all flue-cured tobacco in the world was marketed under contract, and just over half of all world burley was marketed under contract. These arrangements have resulted in part from their lack of access to production inputs, capital, management skills, and technical assistance that are widely available in the U.S. But perhaps the largest influence on their wider use of contracting is lack of a tobacco supply control and price support program or other risk management tools.

In 1999, Philip Morris, the largest purchaser of U.S. leaf, introduced the idea of a program to purchase tobacco directly from growers, but did not implement the program. Also in 1999, several U.S. companies, including Star Scientific and R.J. Reynolds began contracting for flue-cured tobacco with lower tobacco-specific nitrosamines (TSNAs). Then in 2000, Philip Morris announced that they would offer pilot contracts to burley tobacco growers under their partnering program. It is estimated that just under one third of the 2000 burley crop was marketed under contract. Other companies further expanded their contracting programs and by late 2000, the largest purchaser, Philip Morris, announced that they would expand their burley direct purchase program and implement a similar contracting program to directly purchase flue-cured tobacco. By February, 2001, Philip Morris, R.J. Reynolds, Brown and Williamson, and Lorillard had announced that they plan to deal directly with farmers for all or part of their leaf purchases for the 2001 crop rather than purchase through auction warehouses. R.J. Reynolds intends to purchase all of the burley and flue-cured tobacco they will require through contracts; Philip Morris will supplement its contracts with warehouse purchases; Brown and Williamson will buy less than half of its tobacco through contracts, with the remainder to be purchased at auction; Lorillard plans to buy contracted leaf from Dimon.

Most of the tobacco contracts to date have been generally marketing contracts with some production guidelines, where the grower still bears the majority of production risks but reduces price risk. The contracts offered have been for a specified quantity of tobacco and have covered all of a grower's production. The contracts offered have had options for a single year or a three-year contract period. The contracts specify origin, receiving, weighing, inspection, grading, price schedule and rejection terms. Contracted tobacco is still under the tobacco program, so that pounds deducted from the marketing card and no-net-costs are charged, but contract growers are not charged warehouse or grading fees.

Tobacco manufacturers have a number of incentives for movement toward contract production and marketing arrangements. Primarily, a contracting system would allow better control over the specific grades, characteristics, and qualities of tobaccos that the companies desire, especially as the quantity of tobacco produced declines due to reduced quotas. Over time, a contract system could provide growers incentive (quality-related price premiums) to increase tobacco quality. A contract system would also speed the adoption of technological changes, especially important as technologies to lower TSNAs, reduce PAH compounds, and lower nicotine concentrations are emerging. In the event of FDA regulation over manufactured tobacco products, a contracting system would allow tighter management control over leaf inputs and would provide accountability for the raw leaf purchased.

Contracts are pervasive in many sectors of U.S. agriculture. According to USDA's 1998 ARMS data, more than one third of the value

of all agriculture was produced under contract. Production contracts accounted for \$27 billion (14%) of all agriculture value and marketing contracts accounted for \$40 billion (21%). In 1998, 95% of all poultry value was produced under contract and about half of all fruit, dairy, cotton, and vegetable value was produced or marketed under contract. But some of the producer advantages of contract arrangements in these sectors are not applicable to the tobacco sector. Primarily, contracts allow producers to share price and/or production risks with the contractor. Additionally, they may provide guaranteed market access, improve efficiency, provide access to inputs, capital, technical and managerial advice, help producers manage cash flow, and provide income stability. But none of these are significant problems in the tobacco sector, almost entirely due to the existence of the federal tobacco program. For decades, the tobacco program has provided easy access to ready-made markets and a very high degree of price stability. As a tradeoff for price stability, the program induces quota or quantity instability, although the quota-restricted higher program prices have made tobacco a profitable enterprise despite variability in quota.

While the existence of the tobacco program has made contracts generally less appealing to tobacco growers than producers in other agricultural sectors, widespread and rapid increase in the use of tobacco contracts raises a number of questions about the future of the federal tobacco program. The program is costly to operate and introduces production and marketing inefficiencies. As the current contracting system expands, the ability of the auction system to continue to support the USDA grading service is in question. It is also possible that the auction system could become an outlet for residual, lower quality tobacco, further pressuring no-net-cost assessments. The relationship between auction market prices and contract prices is unclear. Also floating are questions about quota enforcement and collection of assessments.

The economic impacts of widespread movement toward contracting are very different within and without a tobacco supply control and price support program. Within the current tobacco program, growers' cost savings from contracts are eventually passed on to the quota owner (who, of course, is often not the tobacco grower) through higher quota lease costs. As quality improves, buyers' cost savings are eventually translated into higher tobacco quotas. With or without a tobacco program, it is unclear to whom contracts will be awarded in the long run. The number of growers, the size of their operations, and their location will become clearer as contracting and the program evolve over the next few growing seasons.

Without a tobacco program in place, cost savings from the marketing of tobacco are transferred to buyers. Eventually, as quality increases, buyers' cost savings are translated into larger quantities purchased, although in the long run, there is little economic justification for confining tobacco production to traditional tobacco belts. Without a tobacco program, contract growers would bear contract-specific risks such as the risk of growing tobacco that doesn't meet quality standards, risk of not having contracts renewed, and investment and income risk. The degree of competition among buyers and leaf dealers for contracts is uncertain, but many growers fear a lack of competition based on their perceptions of a lack of competition among purchasers within the current auction system. Also, small yield fluctuations could make it difficult for contract producers to cover costs of production as contract prices approach the cost of production without a guaranteed program price to compete with contract

prices. While lower-priced leaf under a contract marketing system without a tobacco program would make U.S. leaf more competitive in export markets, it is unclear whether there would be sufficient competition among buyers and leaf dealers to ensure global competitiveness. It is unclear whether a contract system can serve buyers not purchasing all stalk positions as well as an auction system with a stabilization function. Also, absence of government-enforced contract disclosure requirements could weaken market signals and competition.

Agriculture-Related Uses of Tobacco MSA Payments

Cigarette manufacturers reached a settlement with 46 states over state claims against the tobacco industry on November 23, 1998, committing manufacturers to pay participating states \$206 billion over the next 25 years, although the exact amount of future settlement payments is uncertain as payments are subject to annual adjustments for changes in cigarette consumption, inflation, and other factors. The tobacco Master Settlement Agreement (MSA) places no restrictions on state spending of settlement payments. Terms of the settlement direct payments to each state's general fund. Thus, decisions regarding spending state tobacco settlement funds generally rest with state legislatures. All 43 states that have made decisions about spending settlement dollars have allocated some portion to health priorities. Most of the states (38 of the 43) have allocated some settlement monies to tobacco use prevention and reduction. Other health uses include programs for the elderly, prescription drugs, Medicaid, research and chronic diseases. Many states have also allocated money toward education uses including scholarships, school construction, technology, and literacy, among others. Most of the major tobacco-producing states have targeted some portion of their MSA payments to programs related to agriculture and/or rural communities. The following section describes the use of MSA payments in major tobacco states, especially uses targeting tobacco growers and agricultural development.

North Carolina. North Carolina expects to receive about \$4.6 billion in MSA payments over the first 25 years covered by the settlement. To date, North Carolina has received about \$200 million in MSA payments. Legislation was passed and signed into law in 1999 establishing a non-profit corporation for economic assistance to tobacco dependent communities (the Golden LEAF Foundation) with 50 percent of the state's MSA payments. The other half of the payments are to be divided equally between two trust funds: one for tobacco producers, quota holders and tobacco workers and the other for health-related interests. Golden LEAF has just finished the first round of grants awarding more than \$5 million to 39 projects including alternative crops, education, research, economic development, and alternative employment. Most of these monies will target the eastern flue-cured region, although significant funding will also go to the western burley region. Uses for the 25% of settlement fund payments allocated to the Tobacco Trust Fund have not been determined, but possible uses include assisting tobacco farmers in converting curing barns to reduce nitrosamines or giving college scholarships to children of tobacco farmers.

Kentucky. Kentucky expects to receive about \$3.5 billion in MSA payments over 25 years and has received about \$150 million to date. In 2000, the General Assembly voted to allocate 50 percent of all settlement funds through 2002 to agriculture, 25 percent to early childhood development programs and 25 percent to health initiatives, with \$69 million reserved for a "Bucks for Brains" education endowment.

Of the \$180 million expected in the agriculture fund through 2002, \$40 million will ensure a minimum support level under Phase II. \$49 million will be available to county ag councils for local uses, such as low interest loans, grants for water line extensions, transitioning to other farm enterprises, and environmental stewardship. The remaining \$91 million allocated for statewide ag development projects will benefit agriculture by developing regional farm markets, supporting small farm diversification, sharing some of the costs of complying with the state water quality plan and other environmental targets, providing municipal water in prime agricultural areas, and developing farmland preservation programs.

Tennessee. Tennessee expects to receive \$4.8 billion in MSA payments over the first 25 years covered by the settlement and has received over \$200 million to date. In 2000, the Tennessee legislature decided to split current payments between two funds: one for health and one for agriculture. Legislative committees for each fund have recently made spending recommendations to the General Assembly. The agriculture committee is recommending that about \$60 million be used to fund agricultural development programs—in the areas of (1) alternative agricultural development, (2) agribusiness and industrial infrastructure, (3) creation/expansion of agricultural processing facilities, (4) agricultural marketing development, and (5) agricultural production efficiency and effectiveness—and educational financial assistance programs. They are further recommending that half of all future MSA payments to the state go to an agriculture fund trust with investment income eligible for expenditure in the same program areas. They also recommend securitization of the future income stream. The legislature will take up the issue this spring and expects the recommended uses to compete with using the money to avoid a projected budget shortfall.

Virginia. Virginia expects to receive \$4 billion over the next 25 years from the MSA and has received \$167 million through December 2000. Virginia passed legislation in early 1999 allocating 50 percent of all settlement payments to a Tobacco Indemnification and Community Revitalization Fund with a governing board that will compensate tobacco farmers for loss of assets and promote economic growth in tobacco dependent communities. The same legislation allocates 10 percent of settlement payments to a youth tobacco use prevention program. The remaining 40% is allocated annually by the legislature and the governor has recently proposed securitization of this portion. In 1999 and 2000, \$62 million of the payments to the Tobacco Fund went to direct payments to more than 42,000 growers and quota owners. Initial grants from the remaining Tobacco Fund include \$6 million to seven community colleges in Southwest Virginia, \$11.6 million to Virginia Tech to develop an institute for research of plant and animal genetics, \$2 million to research on medicinal and other uses for tobacco, and the remainder to fund economic development projects in Southwest and Southside Virginia.

South Carolina. South Carolina's legislature approved a plan allocating the majority (73%) of their expected \$2.3 billion MSA payments (about \$100 million received to date) to health care, including prescription drugs, home and community based care for the elderly, newborn health screenings, and youth smoking prevention. 15% was allocated to compensate tobacco growers and quota holders for production losses, and 12% was allocated for water and sewer infrastructure improvements, primarily in rural areas. The state is planning to securitize their expected future settlement payments and is reviewing securitization proposals.

Other States. Georgia's legislature approved a plan allocating payments through fiscal year 2001 to rural economic development and health priorities. One third of the settlement payments, \$62 million, was appropriated under the One Georgia Fund to four rural economic development projects (funded at \$10 million each) designed to attract businesses to south Georgia and \$22 million was reserved for future economic development needs. Maryland has committed \$11 million from their expected settlement payments to a buy-out program for tobacco growers. The buy-out pays growers \$1 per pound annually for the next ten years for every pound of tobacco in their average annual yield for 1996-98. In return, tobacco growers agree to stop growing tobacco and are required to continue farming alternative crops. The average annual payment is about \$11,000, but varies greatly. Four farmers have received buyout payments to date and around 650 farmers (which is 68% of the state's tobacco farmers) have so far applied to participate. The state expects participation to increase substantially and may require additional funding over the ten year period. The legislature is considering a bond issue backed by settlement funds to pay for the buyout up front rather than spread over 10 years. Ohio has decided to allocate 2.3% of their settlement funds for the next 12 years, or about \$229 million over 12 years, to tobacco farmers and their communities. While Florida settled their lawsuit with cigarette manufacturers outside the MSA, they have considered using a small portion of their settlement funds to assist tobacco producing regions.

Uses of Phase II Payments in Major Tobacco States

The Master Settlement Agreement contained language that called for participating manufacturers to meet with representatives of major tobacco producing states to come up with a plan to help compensate tobacco growers and quota holders for declining tobacco consumption and demand resulting from the settlement. The result was establishment of the National Tobacco Growers' Settlement Trust Fund, which has come to be known as "Phase II" of the tobacco settlement. Phase II calls for participating cigarette manufacturers to pay \$5.15 billion into a national tobacco grower trust over 12 years to be distributed among tobacco-growing states based on each state's share of 1998 tobacco quotas.

Phase II funds may only be used to make direct payments to tobacco quota holders and producers who suffer economic losses due to industry settlement of state lawsuits. Funds cannot be used for agricultural development, warehouses, or any purpose other than payments directly to quota owners and growers. Payments are only for quotas of tobacco types used in domestic cigarettes. According to the agreement, each participating state is responsible for establishing a board to distribute funds among eligible tobacco quota holders and growers. The allocation of funds among the state's quota owners and growers (including owners, lessees, and tenants) is determined by each individual state board. In flue-cured regions, state boards have generally split payments evenly between growers and quota owners. In burley regions, payments have generally been weighted more heavily toward growers or those bearing a larger share of financial risk. The following section describes the status of the Phase II payments in major tobacco states.

North Carolina. Payments to North Carolina flue-cured producers are split 50/50 between growers and quota owners based on lost quota in the payment year. Payments to burley producers are also split 50/50 between growers and quota owners with growers paid

based on pounds actually marketed in the previous year and quota owners paid based on pounds of lost quota in the payments year. Payments in 1999 totaled \$140 million and were distributed to over 100,000 farmers. Payments in 2000 were about \$92 million. North Carolina expects to receive just under \$2 billion under Phase II over the 12 year period.

Kentucky. In Kentucky, payments are divided equally among the quota owner, grower/tenant of the quota, and the growing farm. In 1999 and 2000, the quota owner payment was based on basic quota in the previous year. Payments to growing farms and growers/tenants were based on the average of the previous year marketings and effective quota. Future Phase II payments to Kentucky's growing farms and growers/tenants will be based on the 1998-2000 production history, averaging effective quota and marketings. Payments to quota owners will be based on basic quota owned as of July 2000. The changes in the formula resulted from the experience that anticipation of the Phase II payments drove up quota lease prices and that Phase II payments were viewed by some growers as a way to stay in tobacco production rather than assistance in transitioning out of tobacco. In 1999, Kentucky distributed about \$109 million in Phase II funds. Although only \$84 million in Phase II funds were available to Kentucky in 2000, the legislature allocated an additional \$40 million from their MSA payments to supplement Phase II payments so that they will remain at a consistent level around \$114 million.

Tennessee. Tennessee decided to allocate 80% of Phase II payments to tobacco growers and 20% to quota owners. Payments to quota owners are based on basic quota in the previous year and payments to growers are based on actual marketings in the previous year. In 1999, Tennessee distributed nearly \$29 million in Phase II payments to more than 68,000 tobacco growers and quota owners. Payments for 2000 were nearly \$19 million. Total Phase II payments are expected to be \$390 million over the 12 year period. The state's Phase II board is considering fixing future payments to a benchmark average of quota and marketings to reduce the transfer of payments from growers to quota owners through higher quota lease costs.

Virginia. Flue-cured growers and quota owners in Virginia each receive half of their Phase II flue-cured payments with payments based on basic quota in 1998. Burley growers receive 75% of Virginia's Phase II burley payments with payments based on the average of effective quota and marketings in 1998. The other 25% of the burley Phase II payments are paid to burley quota owners based on basic quota in 1998. The base year will remain fixed at 1998 through 2004. Virginia expects to receive \$357 million in Phase II payments over 12 years.

Other States. Phase II payments in South Carolina and Georgia are split 50/50 between flue-cured growers and quota owners. Payments to Georgia quota owners and growers and to South Carolina quota owners are based on basic quota in the previous year. Payments to South Carolina growers are based on actual marketings in the previous year. Each state distributed over \$20 million to more than 10,000 growers and quota owners in 1999 and over \$15 million in 2000. South Carolina expects \$339 million over the 12 year period and Georgia expects about \$300 million. In addition to the six major tobacco producing states, eight other states—Ohio, Indiana, Florida, Maryland, Pennsylvania, Missouri, West Virginia, and Alabama—share just over 5% of all Phase II payments.