Tobacco Contracting in Burley Tobacco:

The Kentucky Tobacco Task Force Study of Tobacco Contracting

Research Report #301

Legislative Research Commission

Frankfort, Kentucky
November, 2001

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LEGISLATIVE RESEARCH COMMISSION

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Robert Sherman
Director

MEMORANDUM

TO: Senator David Williams, President of the Senate
Representative Jody Richards, Speaker of the House
Members of the Legislative Research Commission

FROM: Senator Vernie McGaha, Chair
Tobacco Task Force

SUBJECT: Tobacco Task Force Study of Tobacco Contracting

DATE: December 15, 2000

The Tobacco Task Force has completed the first part of its study of tobacco contracting to fulfill the requirements of Senate Bill 49. The Tobacco Task Force has now completed all of the requirements of Senate Bill 49 by holding four meetings, monitoring the opening day of burley tobacco sales on November 20, 2000 and submitting a report of the Task Force on tobacco contracting to the LRC and the Interim Joint Committee on Agriculture and Natural Resources by December 15, 2000.

The current report being submitted to the LRC and the Interim Joint Committee on Agriculture and Natural Resources is the first part of a two part study of tobacco contracting to be completed in the spring of 2000 when the 2000 burley tobacco sales data for both auction and contract tobacco is available. Sales data from the first year of tobacco sales under contracting will not be available in time to meet the December 15, 2000, deadline specified in Senate Bill 49. Therefore it was felt that to fully complete the intent of the General Assembly in seeking a study of tobacco contracting, the report should be done in two parts. This first part of the study report details the background to tobacco contracting and the work done by the Tobacco Task Force in completion of the requirements of Senate Bill 49. The final part of the study will include all of the 2000 burley tobacco sales data and updated information on both auction and contract tobacco sales.

Thank you for your consideration in this matter.

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BACKGROUND OF TOBACCO CONTRACTING AND STUDY REPORT

Introduction

Webster's Dictionary lists a crisis as "a time of great danger or trouble, whose outcome decides whether possible bad consequences will follow." This is applicable in describing legislative activity surrounding tobacco contracting over the past several months. What needs to be understood is the urgency and sense of crisis that brought tobacco contracting to the attention of the General Assembly in the middle of the 2000 session. Tobacco producers and tobacco groups were extremely concerned that the impending beginning of contracting would mean the end of the tobacco program.

In responding to this sense of crisis, the legislators looked for a reasonable and appropriate response to the situation. The end result was the compromise that lead to the final form of Senate Bill 49 and the resulting study on contracting. From the hearings that the Tobacco Task Force held in the study directed by Senate Bill 49 has evolved a much more nuanced understanding of tobacco contracting and how contracting has affected the tobacco program as a whole.

Two Part Report for Tobacco Contracting Study

The current report is the first part of a two part study of tobacco contracting to be completed in the spring of 2000 when the 2000 burley tobacco sales data for both auction and contract tobacco is available. Sales data from the first year of tobacco sales under contracting will not be available in time to meet the December 15, 2000, deadline specified in Senate Bill 49. To fully satisfy the request of the General Assembly regarding tobacco contracting, the report is in two parts. This first part of the study details the background to tobacco contracting and the work done by the Tobacco Task Force in completing the requirements of Senate Bill 49. The second part of the report finalizes the study and includes all of the 2000 burley tobacco sales data and updated information on both auction and contract tobacco sales.

Current Situation

Events and time have moderated the sense of crisis that existed during the 2000 session. The "partnership program" of contracting for tobacco has been implemented as an alternative method of marketing under existing federal law and the current tobacco program. Tobacco farmers currently have a choice of contracting or using the traditional auction marketing system. At least in the short term, the two marketing systems will coexist. One witness testified that contracting will not destroy the auction system but will lead to a dual track system in which there will be benefits and disadvantages to each track, but both will remain in place for the immediate future. The status quo in burley tobacco is a dual tobacco marketing system which provides advantages, choice, and protection to burley tobacco producers, particularly small producers. However, there still are concerns about the long-term viability of the auction system and the tobacco program as a whole because of the effects of contracting.

Requirements of Senate Bill 49

In the 2000 Session, the General Assembly passed Senate Bill 49, which called for a study of tobacco contracting, specifically focusing on potential effects on small tobacco farmers, farm income, and how to support the federal tobacco price support program. Senate Bill 49, the first section of which addresses tax exemptions for emergency tobacco loss assistance payments (TLAP) was amended late in the session to add to the original bill sections two and three, which focus on tobacco contracting. In those sections, the General Assembly directed the Tobacco Task Force to hold meetings and seek testimony from tobacco groups on contracting and issue a report.

Section two of the bill states that "the tobacco price support program is the best and most efficient means of preserving the economic health of thousands of tobacco farms throughout Kentucky," and the "Tobacco Task Force shall study methods to support the Tobacco Price Support Program and its continuing role in the economic vitality of Kentucky's small tobacco farmers."

Section three of Senate Bill 49 directs the Tobacco Task Force "to study the development of contracting for tobacco growing and purchasing, study the effects of tobacco contracting on tobacco income, and examine…the role of the state" regarding tobacco contracting. The bill also requires the Task Force to hold at least four meetings addressing the issue of contracting; monitor the opening day of the 2000 burley tobacco market; consider the treatment of small producers by the companies contracting for tobacco in the 2000 growing season; address potential discrimination against small tobacco producers; take testimony from tobacco groups, tobacco companies, growers from various regions of the state, and from other states that are proposing or have proposed contracting legislation; structure a proposed framework for possible state regulation of tobacco contracting in Kentucky; and work with other states to attempt to formulate a unified approach to contracting in tobacco.

Development of Tobacco Contracting

Tobacco farmers, warehouses and others in the tobacco industry have been hurt in recent years by severe cuts in burley tobacco marketing quotas. Approximately 65% reduction in burley quota occurred from 1997 to 2000. A rebound in basic quota could occur next year due to reductions in the supply of excess tobacco through pool stock sales by the tobacco cooperatives and federal assistance in having the 1999 burley tobacco crop declared a disaster. Even with these reductions in excess supply, experts predict that tobacco quotas will remain at a much lower levels.

Faced with this uncertain supply situation due to falling quotas, tobacco companies have been moving to reduce costs and to ensure consistent quality, supply, and modernized processing in their operations. One approach has been to move to direct marketing contracts for tobacco, instead of purchasing tobacco through the traditional auction marketing system. In testimony to the Task Force, a tobacco company official indicated that concerns over supply security were a major factor in this move toward direct contracts for tobacco. As much as 100 million pounds of tobacco could be sold via direct contracts this year, and although final figures are not yet available, preliminary estimates put the volume of contract sales to one manufacturer alone at over 120 million pounds of burley tobacco. This would represent between one-third to one-quarter of the total anticipated volume of burley tobacco being marketed this year. If that company is successful with direct contracting this year, other tobacco companies may implement direct contract marketing over the next few years.

Another factor in the rise of tobacco contracting seems to be the success that other large agricultural companies have had with contracting in many other commodities. The tobacco companies, realizing that tobacco may be sold under federal law either through a warehouse auction system or by contracting directly with the farmer (provided that the producer does not exceed his or her federal quota, the maximum amount of tobacco the farmer is allowed to market or sell), have moved to institute a contract marketing system directly with farmers under the current federal tobacco program. The warehouse auction system, where producers bring their tobacco to warehouses and companies participate in the auction, has been the traditional marketing method since the beginning of the federal tobacco program in the 1930's. Tobacco companies, however, have been dissatisfied with aspects of the auction system for quite some time, feeling that they have been paying premium prices for sub-standard tobacco because of what they feel is an inconsistent federal grading system and lack of production controls in sorting the various types of tobacco from each plant and controlling moisture levels. The tobacco companies have indicated that they moved to a contracting system in order to specify more completely how they would like the tobacco graded, handled, and processed. Certainly other agricultural companies have demonstrated similar concerns about production and processing controls. One result of these concerns has been the phenomenal growth of contract production in U.S. agriculture in the last ten years.

The Farm Services Administration (FSA) director for Kentucky, discussed contracting in burley tobacco and how it has evolved and can be incorporated under the federal law that regulates the tobacco program. He said that, in general, direct contracting of tobacco is permitted under the program as long as farmers stay within the guidelines of their quota. Farmers have the option of using the marketing system of the auction warehouse or the non-marketing system of contracting, explaining that the federal law on tobacco consists of essentially two different parts. One part regulates production under the quota system, and the other part regulates price and marketing through price supports. The FSA director said the FSA will provide two types of marketing cards: one for the warehouse system and another for the non-warehouse contract tobacco sales. He said that it is very important that farmers who have contracts still comply with quota and not sell more pounds than they have attached to their cards. These rules will be strictly enforced by FSA. However, he said that if a farmer decides at the receiving station the he wishes not to sell by contract, he will have the option to move the tobacco to the warehouse and sell his tobacco through the auction system. This confirms that each aspect of the pilot program was designed to operate within the framework of the United States Department of Agriculture (USDA) tobacco program.

Current Contracting System

If farmers choose to contract for the sale of their tobacco, they deliver their contracted amount of tobacco to a designated receiving station where company officials weigh and grade the tobacco and then assign a price to the tobacco based on a pre-determined price schedule. The tobacco is bought for a set price according to the pricing schedule for the different grades as specified in the contract. If the farmer does not like the grade (thus the price) on the tobacco, the farmer can reject the grade on the tobacco and sell it through the auction market.

This system gives farmers the choice of either selling their tobacco via direct contract or through the auction system. The FSA has said that it would be possible for a farmer to sell part of his crop under contract if he disagrees with the grading and price on only a part of his tobacco. The FSA has stated that any pounds of tobacco not sold under contract will be put on the traditional marketing card for the growers. However, they noted that it would be up to the contracting company. The standard manufacturer's contract states that if sellers disagree with the price of one basket of tobacco they must then disagree with the prices of all the baskets i.e., there will not be a partial purchase of the tobacco.

This opens the question of whether the farmers who either reject the grade on their tobacco or do not choose to contract from the outset this year would be able to contract next year. The buying company testified that the rejection of a grade by farmers would not affect the ability of the farmer to sell to the company in future years and even left open the possibility that it would buy portions of a farmer's crop. Other tobacco organizations and farmers have warned in testimony that one of the largest dangers of contracting was whether the farmer was really "free" to reject the buyer's grade on tobacco and take it back to the auction floor.

Effects Of Tobacco Contracting

Up until this year, tobacco marketing was almost exclusively through the warehouse system and very little through the non-auction system. However, one company has begun direct contracting of tobacco largely because of the example of contracting in other agricultural commodities. This success of contracting in other commodities indicates that companies can more tightly control production and supply uncertainties through contracts, particularly if they are faced with needing large volumes of consistent quality and quantity of a commodity. A company official indicated that supply security, or, in his words, the company's inability to purchase a consistent, high-quality supply of the quantity, grades, and types of burley tobacco used in its cigarettes, prompted his company to begin the pilot program. He said that because of the forty-five percent quota cut for the 2000 quota from 1999 and the fact that the company is the largest purchaser of U.S. burley, the company felt that they were facing a supply crunch of quality burley and they wanted to act to ensure their supply security and stability.

Contracting will have an impact on the traditional auction marketing system of price supports but not on the quota system because the company's partnership program of direct contracts is in compliance with limiting the amount contracted for the amount of the quota. The contracts for tobacco currently being offered to producers only contract for as much tobacco as the producer has available under the quota system. However, if most tobacco is sold via direct contracts, some experts and groups say this may threaten the continued viability of the price support system, including the farmers cooperatives that run the tobacco program. They argue that the danger is that no one will sell tobacco under the auction system because of the warehousing and grading fees and because of the price disadvantages for auction tobacco versus contracted tobacco.

Additionally, the groups feel that the federal grading service will be undone because of the loss of grading fees to contract tobacco. Finally, the groups argue that if the tobacco program no longer exists then contracting in tobacco will lead to a precipitous drop in tobacco prices because of oversupply, reduced demand, and competition against lower world market prices. The groups argue that existence of the price supports to date have held prices high by forcing companies that want to purchase tobacco with direct contracts to match and in some cases exceed the support price for the grades that they want. A receiving station operator and auction warehouse owner testified to this effect saying that as long as the auction system remains in place, it ensures that farmers receive competitive prices on grades of tobacco and prevents companies from writing into contracts unfair practices or even processing that they require of farmers. He testified that the companies are checked by the ability of the farmers to go to the auction market, because the auction market and price support system protect the farmers by ensuring a minimum price as an option.

Because of the approximately 65% reduction in tobacco quota from 1997 to 2000, farmers have been faced with drastic reductions in tobacco and farm income. Tobacco farm income losses have been cushioned in the short term by emergency assistance payments from the Master Settlement Agreement, Phase II assistance fund for tobacco farmers and Federal emergency Tobacco Loss Assistance Payments (TLAP). Additionally it looks as if basic quotas will rebound and even rise next year due to reductions in the excess supply of tobacco. However, even with these aids, experts predict that tobacco quotas and, correspondingly, tobacco farm incomes are unlikely to return to previous levels. Faced with this situation, many farmers are looking to maximize their return on their tobacco this year. As several farmers indicated in testimony, one reason behind seeking to contract was that they would get more money for their tobacco if they contracted. An examination of the buyer's pricing schedule indicates that for premium and high quality grades that the contracted tobacco would bring higher or equivalent prices as compared to the auction support price for those same grades. Additionally since auction tobacco pays warehouse commissions and fees and grading fees, which are not paid on contract tobacco, farmers that have contracted tobacco save paying those fees as well.

The latest statistics from the USDA indicate that for the 2000 burley tobacco sale season as of December 7, 2000, 142,775,526 pounds of tobacco have sold for an average price of $196.44 per hundred pounds. At the same time a year ago, 307.7 million pounds of tobacco had sold for $190.33 per hundred pounds. This represents more than a 50% decline in the volume of auction tobacco sales as compared to a year ago. Tobacco contracted directly from growers reported through December 7, totaled 49.3 million pounds and averaged $197.92 per hundred pounds.

Additionally, the tobacco contracted directly averaged a higher price per hundred pounds than the auction tobacco, $197.92 for the directly marketed tobacco versus $196.44 for the auction tobacco, even before warehouse and grading fees, which range approximately from seven to twelve dollars per hundred pounds. So a farmer selling tobacco through direct contracts is likely to gross on average eight to thirteen dollars more per pound than the farmer that sells tobacco through the auction marketing system. A receiving station operator in testimony estimated that the price benefit to farmers is significant due to the fact that the prices for the tobacco sold at the receiving station are about what farmers would get at the auction market or higher, because a buyer can pay more for the grades it wants and because the farmers at the receiving stations pay no warehouse fees, farmers can make ten to twenty cents more per pound with contracting than with auction sales.

Warehouses are also directly affected by this shift from marketing tobacco through the auction system versus the direct contract marketing. Some warehouses have been able to become receiving stations for contract tobacco or to find alternative uses for the warehouse, but the outlook for warehouses as a result of contracting seems bleak. Twelve out of one hundred-twenty warehouses have closed this year according to the Burley Auction Warehouse Association, with as many as 40 to 50% expected to close next year, depending on the level of contracting. What has surprised many warehouses this year is the magnitude of contracting among the farmers, who despite telling the warehouses that they would bring their tobacco to the warehouses, contracted instead. This was largely due to favorable prices as well as not having to pay warehouse, grading, and hauling fees. The fear expressed by the Burley Auction Warehouse Association is that many of these old warehouses in small towns may be left abandoned for lack of funds for renovations and lack of uses for the structures.

In discussing why the warehouses are facing problems, a receiving station operator and warehouse operator testified that comparing a company receiving station and warehouses, what is different between the two is the efficiency and quality control that make the receiving station a very modern operation. For example, the receiving station operator in discussing the efficiency of the receiving stations testified that the receiving station had thus far been very successful because it was much faster at processing, handling, and shipping the tobacco, and he was able to process more tobacco through one receiving station than the three warehouses will process combined, adding that he has also hired more employees at the receiving station than at the three warehouses combined. He continued by saying that he has twelve warehouses that can be used for tobacco and this year he was using three for auction tobacco sales and one as a receiving station, closing down the others. He indicated that most closings were due to the very large quota cuts rather than contracting. He testified that in areas close to receiving stations a big percentage of tobacco was going to the receiving stations versus auction warehouses, but as you move away from the areas around the receiving stations, more of it goes to the auction warehouses.

Role of the State in Tobacco Contracting

Tobacco is a federal program, governed by federal law so state regulation of the tobacco program or tobacco contracting must be in conformity with federal law. Past proposals for the regulation of tobacco contracting have included some form of state agency review of contracts or requiring all contracts to conform to a standard or "model" contract that a state agency would negotiate or establish with the tobacco companies. Other proposals have included waiting periods, protections for producers to prevent early termination of contracts, disclosure requirements, non-exclusivity and other limitations on contracts. Groups that favor these approaches argue that what these proposals would attempt to do is generally to make contracts more transparent and easily understood by the average farmer giving the producers leverage, protection and information, so that they understand the obligations and restrictions incurred under the contract and know the recourses and protections that are available to them.

One example of state regulation of tobacco contracting is provided by a 2000 Georgia law that instituted a three day waiting period on contracts. It provides the farmer with a three day period during which he can revoke the contract without penalty. For further details of this law, see Appendix G.

ACTIONS OF THE TOBACCO TASK FORCE:

RESEARCH AND TESTIMONY DIRECTED BY SENATE BILL 49

The following sections review the actions taken by the Tobacco Task Force in completing its study of tobacco contracting. They detail the meetings, the testimony requested of the various groups involved with tobacco contracting, and the research that the Tobacco Task Force conducted as specified by Senate Bill 49. Any testimony that is not directly discussed either in the sections below or in other parts of the report can be found in the minutes of the Tobacco Task Force meetings.

Four Meetings Held by December 15, 2000

Senate Bill 49 directed the Tobacco Task Force to hold a minimum of four meetings on tobacco contracting. These four meetings were held in July, August, November and December of 2000. On July 31, 2000, the Tobacco Task Force reviewed Senate Bill 49 as it related to tobacco contracting; heard testimony from the Farm Service Agency relating to tobacco contracting; and heard testimony from four farmers, two that contracted with a tobacco company and two that chose not to contract. On August 28, 2000, the Tobacco Task Force heard testimony on the company's tobacco contract, its pilot program, and tobacco contracting; and heard testimony from the Burley Tobacco Grower's Co-operative Association on the tobacco contract and tobacco contracting. On November 20, 2000, the Tobacco Task Force heard more testimony on tobacco contracting and receiving stations; and heard testimony about tobacco contracting from the Kentucky Department of Agriculture, the Council for Burley Tobacco, the Burley Farmers Advisory Council, and the Kentucky Farm Bureau. Finally, on December 12, 2000, the Tobacco Task Force commented on the proposed draft of the tobacco contracting study report; and heard testimony on tobacco contracting from the Community Farm Alliance (CFA), the Burley Auction Warehouse Association, the Governor's Office of Agricultural Policy, and the Commodity Growers Cooperative Association.

Monitoring Opening Day of the 2000 Burley Tobacco Sales

The Tobacco Task Force met on opening day of the 2000 burley market in Horse Cave, Kentucky, at the People's Tobacco Warehouse. The Chair and several members of the Task Force spoke to the assembled crowd before the sales began. Additionally the members of the Task Force were on hand to talk to farmers about contracting versus the auction tobacco marketing. Later that day, members of the Tobacco Task Force went to Glasgow, Kentucky, to see a receiving station in operation and compare the warehouse with the receiving station.

Testimony and Research on the Treatment and Potential Discrimination Against Small Producers Under Tobacco Contracting

One of the worries when contracting was first tried was that the small tobacco farmers would be severely hurt by a wide scale move to contracting. So far that result has not happened. Clearly the central question is, Why? What are the factors that are allowing small tobacco producers to stay operational in a highly competitive environment with contracting and severe cuts in quota?

The majority of Kentucky tobacco farmers are small farmers. A USDA report on the tobacco program, including quotas from 1990 to present, shows that 65% of Kentucky farmers have less than 1000 pounds of quota and 1% have more than 10,000 pounds. The 1997 census of agriculture conducted by the National Agricultural Statistics Service of the USDA indicates that of the 45,000 tobacco farms in Kentucky, over 35,000 of those were ten acre farms or smaller. As a leading expert in burley tobacco production noted in a recent report, in over 75 percent of these farms growing tobacco in Kentucky, tobacco accounts for at least one-half of their agricultural sales for 1997. The report goes on to conclude that because of this dependence on tobacco, any structural change in U.S. tobacco farming would have significant impacts on Kentucky and Kentucky's small farmers, saying that even a slight increase in the average tobacco production per farm in Kentucky under a contracting system would result in the elimination of over 50% of the Kentucky tobacco farms necessary to grow a tobacco crop at recent production levels.

A key to the thinking of the General Assembly on the importance of protecting the small tobacco farmer is found in the opening statement of the section on tobacco contracting in Senate Bill 49 which says, "the General Assembly declares that the Tobacco Task Force shall study methods to support the Tobacco Price Support Program and its continuing role in the economic viability of Kentucky's small tobacco farmer.". Given this statement, the role of the price support program in preserving the competitiveness of the small tobacco producers needs to be examined carefully.

When the Tobacco Task Force first opened hearings on tobacco contracting in July, one of the first things they did was to have both large and small farmers come in and speak on both sides of the contracting issue. What emerged in the testimony is that under the current tobacco contracts, it appears that contracts are offered to small producers as readily as to large producers. Company representatives explained this by saying that they want small growers as readily as large, so long as growers meet quality standards for grades and styles of tobacco. They went on to indicate that there is a wide range of growers participating in the pilot program, but forty-eight percent are small growers with five thousand pounds or less of quota.

In testimony before the committee it appears that larger farmers were contracting because they felt that they could save money over the long run with contracting by not having to pay the warehousing and grading fees. In a situation where these fees can run eight to thirteen cents per pound of tobacco, if the farmer has a high volume of tobacco this savings can be significant. For example, comparing the auction market price average to the direct contracted price average for the first week, the auction tobacco sold at 196.62 on average per hundred pounds compared to the contracted tobacco at 197.78 for the same period. That would mean an average earnings per hundred pounds of between eight to thirteen dollars per hundred pounds more for the contracted tobacco over the auction market tobacco. Because of this price advantage, the large producers seem to favor the contracting system.

Another concern to the large producers are the high prices that they have to pay for leasing tobacco. One producer testified that he had 100 leases this year, with no more than about 1100 or 1200 pounds on each, which meant that he had to pay 65 cents for tobacco quota, cutting into his profits. He said that he could raise tobacco cheaper if the federal tobacco program were not around and he did not have to lease tobacco quota. He said with contracting, even under the federal tobacco program, there is no commission and no warehouse fees and he can raise tobacco for \$1.40 to \$1.50 per pound, which makes growing a lot more profitable. Another rationale given by farmers for moving toward contracting was expressed by another producer who felt that the price support system is going to end in two to five years. He felt that later on the companies will want fewer people to grow tobacco and he wanted to be one of those farmers.

In testimony, the growers who spoke against contracting spoke generally in favor of the auction system and how it protects smaller growers. They testified that one way that the auction system protects the smaller growers is that it provides a price that contracting companies must match to be competitive. One farmer testified to this effect when he stressed that the federal price support program has been beneficial to both farmers and companies, adding that he knew people who had farmed before the tobacco program who used to receive very low prices per pound for their tobacco. He felt that because one company wanted to change it, the program is in jeopardy, and he felt that any change should be taken very cautiously.

Another farmer testifying against contracting discussed the profit advantage to selling tobacco via contracting. He said there is a short term price advantage with contracting, but he felt that the contract prices are also a disadvantage because the contract is for one year only. He added that in the long run his trust is in the program, which outweighs the short term benefits that the farmers who contract will get this year. One fear about contract prices expressed by the farmers and other agricultural organizations has been that the tobacco companies are using the contract prices to attract farmers into contracting rather than the auction system until the price support system is undermined. The fear is that the USDA grading service would decline due to lack of grading fees. This issue will be discussed in greater detail later in this report.

Testimony to the Tobacco Task Force Regarding Tobacco Contracting

The following sections detail testimony requested and taken from tobacco companies, tobacco groups, farmers, and other organizations and individuals directly involved regarding tobacco contracting as required by Senate Bill 49. Two groups that are directly involved and affected by tobacco contracting that were not mentioned specifically in Senate Bill 49 have also provided testimony. These groups are the Burley Auction Warehouses Association and the Commodity Growers Cooperative Association.

Tobacco Companies

Currently only one tobacco company is actively engaged in a direct contracting system with growers, using its own graders and warehouses or receiving stations. Much of the company testimony is detailed in other sections of this report, but several key points about the pilot contracting program that are not discussed in other parts of the report appear below.

First, the company does not anticipate meeting all of is burley tobacco needs this year from the pilot program and will buy from the auction system for the remainder of the needed burley. Second, the company testified that the pilot program and the contracts with growers under the program are marketing contracts. Unlike production contracts, the tobacco grower is not a part of the company so the company does not tell the grower, an independent contractor, how to grow tobacco, Tobacco organizations and farmers argued that the contracts do have certain production aspects to them, notably processing requirements of sorting out three to four stalk positions for separate baling of the tobacco and moisture content levels of the tobacco. Finally, the company testified that it had made three major changes in the current contracts due to feedback from the growers, including providing for more frequent grading of the tobacco, providing for same day payment for growers, and increasing the prices on some grades to make them more competitive with the auction system prices.

Tobacco and Agricultural Organizations

This group includes the major tobacco and agricultural organizations involved with tobacco in Kentucky such as the Burley Tobacco Growers Cooperative Association, the Council for Burley Tobacco, the Burley Farmers Advisory Council, the Kentucky Farm Bureau, the Community Farm Alliance, the Commodity Growers Cooperative Association, and the Burley Auction Warehouse Association. All but the last two were specifically designated in Senate Bill 49.

Tobacco and agricultural organizations, notably the Burley Tobacco Growers Cooperative Association, testified that contracting needs to be regulated now because current pilot contract buying and quota cuts will force other companies to use contract buying next year. They believe that farmers were not in an equal negotiating position. They and other groups such as the Kentucky Farm Bureau, the Council for Burley Tobacco, the Burley Farmers Advisory Council, and the Commodity Growers Cooperative Association, advocate incorporating tobacco contracts into a more general approach to regulating agricultural contracts for all commodities. To this end, model legislation developed by the National Association of Attorney Generals (NAAG), has been endorsed by the Kentucky Attorney General. This proposal seeks to cover both marketing and production contracts for all commodities including tobacco. A variation of the NAAG proposal has been put forth jointly by the Kentucky Farm Bureau and the Burley Tobacco Growers Cooperative (Appendix C, statement #4). This proposal would have slight modifications and be formulated more specifically to Kentucky's tobacco needs. The Kentucky Farm Bureau noted in testimony that the modified version included processors' agents in the legislation, gave the producers more time to make decisions, and contained ideas from other states and other state Farm Bureaus. The Kentucky Farm Bureau and the Burley Tobacco Growers Cooperative felt that the key framework of the legislation was to give the farmers more control and to protect the producers. The Kentucky Farm Bureau testified that the intent of the proposal was to keep market competitiveness in all commodities by not over regulating contracts. Their proposal, they said, provides producers a level playing field and ensures that contracts disclose full information so that producers know what they are entering into before they sign contracts.

Additionally, tobacco and agriculture organizations testified that the grading situation is a severe problem. They feel that because the tobacco program is comprised of two separate systems — quotas and price support — the loss of grading fees, the U.S. grading service, and graders threatens the price support system. They argue that under the auction system all burley tobacco is graded by USDA certified graders and under federal law all USDA graded tobacco has to be given a price supported by the federal government. But since the law does not require that all tobacco have a USDA grade, a company can grade contracted tobacco with its own graders.

The groups contend that the threat comes from the fact that the U.S. grading service is primarily financed by the growers through the grading assessment levied on every pound of tobacco in the auction system. Therefore, the more tobacco that is sold under contract means less tobacco graded for auction by the federal graders and less financing for the U.S. grading service, eventually forcing it to discontinue services. They reason that with no USDA grading service under federal law there is no auction system. The Commodity Growers Cooperative Association testified that because contracting buyers may use their own graders, farmers contracting do not have to pay the penny per pound assessment which pays for the federal graders. There will be fewer to pay the auction systems assessment, they say, and eventually the program will collapse.

Producers

Small and large producers across the state testified both for and against contracting. Much of their testimony has been discussed in the earlier section on small producers, but some further points were raised. One farmer testified that the contracts are legalistic and are difficult to understand. There were no attorneys in his area that understood these contracts, and farmers were left to deal one-on-one with the companies. The farmers indicated suspicion and concern about the timing of these contracts — i.e., that the higher prices offered through contracting coincide with the February 2001 vote on the tobacco program. The farmers did not think this fact was a coincidence and asked the Task Force to pay attention to this timing. Finally, the farmers felt that while the contracts are fair and generous now, they will need to wait and see what happens to contract prices over the long run.

Other Interested Organizations and Individuals

This group includes both government organizations and other individuals directly involved in tobacco contracting. The government organizations are the Kentucky Department of Agriculture, the U.S. Farm Service Agency, and the Governor's Office of Agricultural Policy. The individual testimony is by a contract tobacco receiving station operator. The receiving station operator, although associated with a company contractor, is an independent contractor because each facility is separately owned and operated.

The director of the Kentucky FSA office testified that contracting would likely mean additional costs for FSA. The service of having separate marketing cards and market recorders provided to direct contract tobacco will be absorbed into FSA's existing programs, and other FSA services and programs will have to be cut in addition to a possible reduction of graders because of a loss of grading fees. He also indicated that the FSA needs farmers to declare where contracting is taking place so that the FSA can have the right amount of graders in the right areas. He indicated that there is a lot of concern about how much information is currently available to FSA regarding non-auction tobacco—information the FSA requires in order to make decisions about graders.

The Kentucky Department of Agriculture expressed concern over the USDA no-net cost fund system for funding the auction and the price support quota system for tobacco because it is under pressure from pounds being switched from the auction system to the contracting system. The commissioner testified that the ability to get a quick bank loan for a tobacco crop is a direct result of the price support system. He indicated that the impact of changes on small farmers should be studied carefully and suggested the task force re-evaluate the effect of contracting after the tobacco sales season is over and do what is in the best interest of the farmers. The commissioner indicated that if contracting keeps increasing and the auction market levels continue decreasing, the Kentucky Department of Agriculture is concerned about the viability of the program. He said the Department hopes that the level will stabilize and allow contracting to work within the bounds of the tobacco program and concurrently with the auction system.

The Governor's Office of Agricultural Policy (GOAP) indicated it felt a need for a balanced perspective on the issue. They testified that they can see advantages and disadvantages to tobacco contracting but felt a need to consider not only the position of the tobacco farmers but also of the tobacco companies. They felt a need to encourage these two perspectives to cooperate rather than compete on contracting, particularly since contracting has coexisted with the auction system in the first year. Secondly, the GOAP felt that the two marketing systems — contract marketing and the auction market — had a lot more in common than they had differences, and one of the challenges is how to emphasize this commonality rather than let differences divide the two. Lastly, they preferred to explain their position more fully in a written statement included as appendix C, statement #7.

A receiving station operator and auction warehouse operator also testified before the Tobacco Task Force. He indicated that the decision to open the receiving station was a business decision just as it will be for farmers deciding where to take their tobacco. He indicated that state government's role in contracting is to figure out a way to encourage both types of tobacco marketing systems. He indicated that as long as the auction system is in place, then government contracting legislation for tobacco is not necessary, because the auction system currently provides the protection that any legislation would also seek to provide. He indicated that the auction system and farmers have problems that they need to face, including issues of poor quality control on tobacco, grading, sorting, and processing. He said that he has seen signs that tobacco contracting seems to have taken care of the quality problem because now farmers know they have to do the best job they can with the tobacco to sell it. He said that on the grading issue, it will be up to farm leaders to find some way to make contracting and government grading compatible. He testified that he hopes that the auction system will survive and thus make regulation of contracting unnecessary.

Examination of Proposed Frameworks for State Regulation of Tobacco Contracting and Other States' Approaches to Tobacco Contracting

Many tobacco and agriculture organizations believe that the proper framework for state regulation of tobacco contracting would be to adopt either the model contract legislation entitled the "Producer Protection Act" put forth by the National Association of Attorneys General (NAAG) in sixteen states, or a proposed variation of it presented by the Kentucky Farm Bureau and the Burley Tobacco Growers Cooperative Association. Other groups such as the Council for Burley Tobacco, the Burley Farmers Advisory Council, and the Community Farm Alliance emphasized the points of the model contract legislation that they felt are most important, particularly the requirement of plain language contracts disclosing risks, a three day right of review for producers, a prohibition of confidentiality clauses for the producers, a first priority lien to the producers if the contracting company goes out of business, and making it unlawful for processors to retaliate against producers who join producer organizations. The groups advocate the model legislation's goal of promoting fair dealing in all agricultural contracting and including tobacco farmers in this proposed legislation. The only example of such tobacco contracting legislation is Georgia House Bill 1245 of the 2000 session, which passed into law a three-day right of review after signing a tobacco marketing contract. For the full text of this legislation, see appendix G.

The Burley Tobacco Growers Cooperative and other groups have indicated that a simple regulatory framework for grading would be to require companies choosing to contract to use USDA graders and pay the grading fee, or use their own graders and pay the equivalent grading fee to the USDA. The Kentucky Farm Bureau has indicated that it also supports steps to ensure that all tobacco, whether sold through the contract system or the auction system, command a grading fee and that all tobacco, whether sold through the contract system or the auction system, be graded by a federal grader. The Kentucky Farm

Bureau testified that it believes that all tobacco sold should be graded by a federal grader, because using AMS graders allows producers to have an arm's length transaction with the tobacco manufacturers. The Kentucky Farm Bureau has testified that it believes the program can be and needs to be adjusted to ensure that the quota and the price support systems are sustained with contracting. The Burley Farmers Advisory Council also testified that all farmers should pay a grading fee and should have access to federal graders, including farmers contracting their tobacco.

Working With Other States to Formulate a Coordinated Multi-State Approach to Tobacco Contracting

The Tobacco Task Force and other members of the Kentucky General Assembly have attempted to work with other states in formulating a coordinated approach to tobacco contracting. A concerted research effort determined that only one state, Georgia, has either passed or proposed any legislation dealing with tobacco contracting. None of the other tobacco states have taken up tobacco contracting legislation. In another effort toward a coordinated approach to tobacco contracting and agricultural contracting in general, the National Conference of State Legislatures (NCSL) and the Southern Legislative Conference (SLC) held two large multi-state meetings during the past year. With Kentucky support and leadership, the SLC adopted a policy stating that the member states of the SLC support the federal Tobacco Price Support program and oppose any development of tobacco contracting that would undermine the tobacco program. For a the full text of this policy position, see Appendix H.

CONCLUSION

There seems to be universal agreement that tobacco contracting is here to stay. The Tobacco Task Force, based upon detailed testimony about the tobacco system and tobacco contracting, concludes that a number of issues and concerns should be addressed in the next phase of its study.

First, there seem to be four primary issues of dispute: quotas, grading, small versus large producers, and general agricultural contracting. Second, there are other issues that remain unresolved or that may become important as contracting continues. Most of these issues relate to how contracting will evolve beyond this first year. Third, how long will the coexistence of both contracting and auction tobacco marketing that is currently in place and working this year continue, and what are the events that will force a change in this status quo? Fourth, an overview of the possible issues and data to be presented in the second part of the report will focus on providing the statistical and sales data from the 2000 marketing sales for both auction and directly contracted tobacco in addition to updating developing issues in the spring of 2001. Last, the Tobacco Task Force, in light of potential effects upon farmers, warehousemen, and others involved in the tobacco industry, should continue monitoring both warehouse contracting and the tobacco program.

Four Major Issues Relating to Tobacco Contracting

The contentious debate surrounding tobacco contracting and its effects can be reduced to four major issues: quotas, movement toward contracting in other areas of agriculture, small versus large producers, and grading. All four of these issues are major points of contention between producers and tobacco groups on one hand and the tobacco companies on the other. Additionally, all of these issues have significant effects on tobacco contracting and the tobacco system as a whole. These issues have been discussed at various points in the report, but this conclusion will emphasize the main points of each issue as it relates to tobacco contracting.

Quotas

Burley quotas have been reduced by almost 2/3 from their record high level in 1997. Approximately 65% of quota has been cut over the last three years, which has drastically reduced tobacco farmers' income. The 2000 crop year quota cuts were the steepest production cuts ever, with a 45% cut in basic quota from 453 million pounds in 1999 to 247 million in 2000 and a 47% cut in effective quota from 692 million pounds in 1999 to 367 million in 2000. The 367 million pounds of marketing for burley is the lowest production level ever and could force companies to use their existing stock levels, purchase pool stock, and import more burley to ensure against a shortfall of burley production.

These severe quota cuts have impacted all groups involved in tobacco. If direct contracting for 100 to 120 million pounds of tobacco were done in 1999 with an effective quota of 692 million pounds, it would not have had nearly the effect that it will have on the 2000 sales with an all-time low effective quota of 367 million pounds. The producers and organizations put the blame for quota cuts on the tobacco companies, saying that they have to increase their demand for burley to increase the quota back up to more historic production levels. For their part, the companies say that they cannot increase their demand beyond what they can market and say that they are looking for increased quality not just quantity of burley from farmers and the market. Right now it is too early to tell at what level the burley tobacco quotas will stabilize. However, increases in quota takes the pressure off of contracting and the auction system because more tobacco becomes available to market and sell. For a more in-depth analysis and discussion of the burley tobacco quota outlook, see Dr. Will Snell's recently updated situation outlook that is included as Appendix I.

Movement Toward Contracting in Other Areas of Agriculture

Contracting in agriculture is not new in either U.S. agriculture or in tobacco. A recent USDA study indicates that approximately one-third of all products (by value) are produced and/or marketed under contracts. Most poultry is produced under contract, and cattle and pork production is rapidly moving toward being mostly sold by direct contracts. Other commodities such as fresh fruits and vegetables, grains, and other commodities all have some degree of direct contracting.

Agricultural contracts are of two general types: marketing and production. Production contracts are more tightly integrated, providing a price for raising a specific quantity and quality of that particular commodity to be delivered after harvest. Production contracts are often complex, specifying in great detail all aspects of production including type of seed, planting, fertilizing, and harvesting, with the contracting firm generally maintaining ownership of the commodity and thus retaining most of the profit. Marketing contracts typically are much more general, only specifying the price, quantity, quality, and date of delivery for a commodity, with the producer maintaining ownership until sale and delivery. Currently, most U.S. tobacco contracts, with a few exceptions, are primarily market contracts. However, in other tobacco producing areas of the world, such as Brazil, Mexico, and Argentina, companies have moved heavily toward production contracts for tobacco.

Small Producers

Treatment of small producers has been discussed in detail earlier in the report. What can be concluded from this report is that although currently small producers have not been hurt by contracting, there is a possibility of changes in the tobacco program that could have drastic effects on small producers. Continuation of the price support system seems to safeguard small producers by giving them a choice of marketing that they might not have under a contract marketing system only.

Grading

The key question regarding tobacco contracting and grading is whether the reductions in the grading fee payments to the USDA grading service because of contracting hurt the continuation of the auction system because of the lack of USDA graders? The preliminary evidence is that if there is a significant move out of the auction system to contracting, either by other companies or by farmers selling the majority of the tobacco via direct contracting, then it will have very detrimental effects on the USDA grading system.

The controversy over graders stems from company use of its own graders rather than USDA graders for its contracted tobacco and thus not paying a grading fee, which is used to support the USDA graders and federal grading program, on that tobacco. Under the company contracts the tobacco is received, inspected, and weighed on scales certified by the Kentucky Department of Agriculture. Then the tobacco is checked for moisture and put on the grading schedule at the receiving station so that the grower can be there when the tobacco is graded. When the tobacco is graded by a trained company grader, the grower has the right to reject the grade assigned to the tobacco and request that it be graded again by a supervisor, all conducted between company graders and the grower, with no USDA graders available. Company officials were asked in hearing whether they would consider using independent graders, such as USDA or University of Kentucky graders. They answered that grading is important to the transaction, and the company will insist on using its own graders.

The tobacco and agricultural groups argue that with the introduction of contracting, fewer farmers are selling at auction and may have to pay a higher grading fee to cover the costs incurred by the federal graders. They argue that the farmers that go through the auction system are unfairly subsidizing the farmers that choose to contract. This year the budget for the Agriculture Marketing Service, which trains and provides graders for tobacco, was cut because such a large amount of tobacco was sold under contract and thus did not pay the grading fee. The grading fee must be collected on all tobacco to adequately fund the AMS grading department, and it is only a miniscule amount to maintain the viability of the tobacco program.

Other Issues Relating to Tobacco Contracting

Other questions may become important concerns in tobacco contracts. Will there be any effect from the management independence provided to producers? Will there be a reduction of public market information in such areas as prices and quantity of tobacco? Will there be a danger of contracting firms abuse of power over prices and profits to the detriment of both producers and consumers? Will producers be required to make large capital investments? Will premiums or discounts be awarded for quality? And, will their be other provisions that directly affect farmers entering into these contracts? It is too early to tell the answer to many of these questions or to evaluate whether the proposals for regulation of tobacco contracting or contracting in general will address these concerns.

Threats to the Status Quo

Tobacco contracting, just like contracting in all commodities of agriculture, is a fact of the Kentucky agricultural economy due to the continuing consolidation of agriculture in general and among tobacco growers and warehouses specifically. The tobacco contracting movement has already caused change in the current federal tobacco program and the auction system and will likely cause more in the drive to enhance the efficiency and competitiveness of the U.S. burley tobacco industry.

Developing Issues for Second Part of the Study

The second part of this study on tobacco contracting will come after the tobacco sales data for the 2000 burley tobacco market is available for both auction and contract tobacco sales. An issue that may need to be examined is the percentage of farmers that rejected the company's grade for their tobacco. Another possible issue is whether there were any partial sales of contracted tobacco, where part of one farmer's quota was sold on contract and the other part was sold through the auction system. Both of these are issues that could be addressed in the second part of the study when the data from the 2000 sales becomes available.

Continued Monitoring by the Tobacco Task Force

Continued monitoring of developments in tobacco contracting by the Tobacco Task Force is essential to legislative oversight of the situation with direct marketing of tobacco until the status quo stabilizes. However, given the developments of the current 2000 sales season and the success of the company's contracting program it is much too early to say that the situation is a stable one. This instability represents a major threat to one part of the tobacco program, namely the price support system of auction marketing and minimum support prices for various grades of tobacco.

The first hurdle for the price support system comes in February of 2001 when tobacco farmers vote for the continuation or discontinuation of the program and the subsequent no-net cost fund payments that they make to support the program. If the program survives that first test, then it remains to be seen whether the auction marketing system will remain viable and competitive with direct contracting for the next burley sales season or whether it will drop to a much lower level and volume of operation. Finally, a longer term test will be to see if the grading service part of the auction system can survive the reductions in volume of tobacco being graded without compromising the quality and independence of the grading service and whether it will survive at all.

Another unstable situation is the crisis that the warehouses that used to handle auction tobacco are facing. Only a small number of them can and will convert to becoming receiving stations for contract tobacco; another group of them will stay open for the reduced amount of burley tobacco marketed through the auction system; another group will be converted to other warehouse and storage uses. But a large group of them will simply close and remain empty for lack of funds and utilization for them. As the

Burley Auction Warehouse Association indicated in testimony, as many as 40 to 50 percent of the remaining warehouses could close as early as next year, in addition to the 15 out of 120 that closed this year. This is a developing situation that the Tobacco Task Force needs to continue monitoring.

Given these potential situations and more that are not foreseen, the Tobacco Task Force needs to continue its involvement and monitoring of tobacco contracting. Task Force involvement enables the Task Force both to shed light on developing issues before they become crisis situations and to recommend legislative strategies to the Kentucky General Assembly if legislation is necessary.

KENTUCKY TOBACCO TASK FORCE
REPORT ON TOBACCO CONTRACTING ADDENDUM:

PART II — FINAL FIGURES FOR 2000 BURLEY TOBACCO SALES

Since the completion of the initial Tobacco Task Force report, there have been several developments in tobacco contracting. This addendum includes a general update on the contracting situation and gives the final beltwide and Kentucky figures for the 2000 burley tobacco sales, both contract and auction sales. Table 1 provides an overview of these sales. Contract sales of burley tobacco beltwide totaled 87.5 million pounds, 26 percent of the total volume sold. Beltwide auction sales of burley tobacco were 245.9 million pounds, just over 74 percent of total volume sold; 223.7 million pounds were sold to companies, 19.4 million to the burley cooperatives and 2.8 million pounds in other sales.

TABLE 1
2000 Burley Tobacco Sales (in millions of pounds)

	Beltwide	% of Total Sold	Kentucky	% of Total Sold Beltwide
Total Sales	333.4		226.8	68%
Contract Sales	87.5	26%	57.5*	66%
Auction Sales	245.9	74%	169.3	69%

** An additional 8.6 million pounds grown under contract in surrounding states were delivered to receiving stations in Kentucky for sale.*

The Tobacco Task Force completed the requirements of Senate Bill 49 (2000 Ky. Acts ch. 533, sec. 3), but also decided to finalize the tobacco contracting study after the sales data from the 2000 growing season were available in the spring of 2001. During the sales season, tobacco contracts generally remained the same as the contract that was presented in testimony before the Task Force on August 28, 2000. The contracting system seemed to work well with differentiated marketing cards for contracted tobacco and auction tobacco. Producers that disagreed with grades on their tobacco or with any other contracting feature seemed to have been allowed to freely move their tobacco from contract receiving stations to the auction floor with little difficulty. Contracting was seen as a success by the one company that contracted for burley tobacco sales in 2000. Still, a significant amount of tobacco was purchased at auction by the contracting company.

Finally, preliminary indications are that all of the major cigarette manufacturers, many of the smaller manufacturers and most of the tobacco leaf dealers will contract for the 2001 growing season. As of August 2001, 63 percent of the producers beltwide, have indicated that they will market their tobacco via direct contract for the 2001 season, 61 percent in Kentucky. However, there are indications that producers will still support the quota and auction system and thus take a lot of tobacco to the auction market. This will force the companies to still purchase a significant amount of burley at the auction market, ensuring that direct marketing and auction sales will co-exist for at least the present, even at significantly reduced levels of auction sales.

Background

The Tobacco Task Force completed the first part of its study of tobacco contracting to fulfill the requirements of 2000 Regular Session Senate Bill 49 (2000 Ky. Acts ch. 533, sec. 3) and submitted the report to the LRC and the Interim Joint Committee on Agriculture and Natural Resources on December 15, 2000. The Tobacco Task Force fulfilled all of the initial requirements of Senate Bill 49 by holding four meetings, monitoring the opening day of burley tobacco sales on November 20, 2000, and completing the initial report. It was recognized that sales data would not be available in time to meet the December 15, 2000, deadline specified in Senate Bill 49. Therefore, the Tobacco Task Force felt that to fully complete the intent of the General Assembly in seeking a study of tobacco contracting, the report should be done in two parts.

The first part of the study report detailed the background to tobacco contracting and the work done by the Tobacco Task Force in completing the requirements of 2000 Senate Bill 49. This addendum represents the second and final part of the study and includes all of the 2000 burley tobacco sales data and updated information on both auction and contract tobacco sales.

Tobacco Contracts

As stated in the first part of the report, burley tobacco contracts, which were only offered by one company in the 2000 growing season, were essentially marketing contracts with some limited production guidelines. If the producers sold tobacco via contract instead of auction, even for the same price, the net for the producer was lower at auction because of the fees that are paid by the producer when selling at auction. This difference is reflected in Table 2.

TABLE 2
2000 Beltwide Sales - Burley Tobacco Prices, Fees, and Producers

	Contract Sales	Auction Sales
Price per pound	$1.98	$1.95
Fees	None	$ .11
Net to producer	$1.98	$1.84
Number of contracts	10,749	Not Available

These fees include the no-net cost and burley promotion fees, which under the contract the company paid instead of the producer, as well as grading and warehouse fees, which are not paid when the tobacco is sold under contract. These fees pay for federal grading, and the stabilization costs. The loss of these fees is why many feel that the tobacco program is threatened if burley tobacco sales switch to contract sales.

If they contracted their tobacco, producers had their tobacco graded by the company. If they were unhappy with the assessment of grades on their tobacco, they had the option of getting a second opinion from another on-site grader and, if still unsatisfied, of pulling their tobacco off the sales floor and delivering it to auction to sell. Even though growers signed a contract with the company, they were permitted to place their crop on the auction floor if they so chose.

These contract purchases were on an all-or-nothing basis, with farmers required to reject the contract price on all of their contracted tobacco if they disagreed with the offered price for any graded "basket" of tobacco. This practice was adopted to prevent growers from accepting the offered price on the highest grades of tobacco but rejecting the price offered on lower grades. Partial rejection could have forced the company to purchase a disproportionate volume of low grade tobacco at auction. Growers were also required to contract their entire burley quota allotment.

Contract Sales in 2000

In the first year of direct contracts, the contracting company signed 10,749 sellers to contracts beltwide. These contracts generated 87.5 million pounds of burley tobacco, 26 percent of the total poundage sold. As shown in Table 2, contract prices were high, with the average price of burley tobacco sold under contract running at $1.98 per pound and $198.43 per hundred pounds. The contracts with the producers ranged from under 100 pounds to over 200,000 pounds. Significantly, 54 percent of the contracts were with small producers growing less than 5,000 pounds.

Kentucky producers had 57.5 million pounds of contract burley tobacco purchased from farms located in Kentucky, representing 66 percent of the total volume sold under contract. There were 66.1 million pounds of contract tobacco purchased at Receiving Stations located in Kentucky, 76 percent of the total volume sold under contract. This difference of 8.6 million pounds of burley tobacco that was in effect imported into Kentucky indicates that the Kentucky contract receiving stations served as a centralized location for burley tobacco leaf operations, taking in tobacco from surrounding states. In Kentucky there were 7,096 burley tobacco contracts signed with sellers, 66 percent of 10,749 total contracts with sellers beltwide. However the company indicates that they, "do not have specific data to identify the number of producers that may be involved with each seller." Table 3 compares 2000 sales to 1999 sales and projected 2001 sales.

TABLE 3
Burley Tobacco Sales – Kentucky Only *(in millions of pounds)*

	1999	2000	2001
Total Sales Volume	413.6	226.8	232.9 (estimated)
Contract Sales	None	57.5 (66.1 to receiving stations in Kentucky)	61% designated to contract receiving stations in Kentucky
Percentage of Kentucky Contract Sales of Total Beltwide Sales Volume for Contract Tobacco	None	66% (76% to receiving stations in Kentucky)	Not Available
Number of Contracts	None	7,096	Not Available
Auction Sales (Kentucky's percentage of total beltwide auction sales)	413.6 (71%)	169.3 (69%)	39% designated to auction warehouses in Kentucky
Number of farms selling via auction in Kentucky	123,172	Not Available	22,078 (estimated based on designation)

- The 2001 sales volume is estimated based on the 2001 effective quota for Kentucky, from the *Burley Tobacco Poundage Quotas, 2001* as reported by the Kentucky Agricultural Statistics Service.
- The number of farms selling via auction figure is provided by the Burley Tobacco Growers Cooperative Association and are based on Kentucky Agricultural Statistics Service figures and September designation figures from the USDA and FSA.

Despite the fact that previous estimates of the volume of contracted leaf from the first part of the report indicated that the contracts would bring in approximately 110 million pounds or more, this volume was still seen as a success by the contracting company, particularly because of the high quality of the tobacco sold under contract. A likely reason for the actual volume's being lower than previously estimated was that farmers had a very good growing season with very high quality tobacco available (in sharp contrast to 1999, when most of the crop was very poor) and the resulting high auction prices on this high quality tobacco. Because of this, many farmers who had contracted their tobacco may have moved their tobacco to the auction floor.

The contracting company stated repeatedly that it did not anticipate meeting all of its tobacco needs through contracting and did purchase a significant amount of burley on the auction market. Despite other companies' moving to direct contracting, it looks as if direct marketing and auction sales will co-exist for at least the present.

Auction Sales in 2000

For the 2000 growing season, gross volume of burley tobacco sold beltwide at auction was 245.9 million pounds, 74 percent of the total volume of burley tobacco sold; 223.7 million to companies, 19.4 million pounds to the burley cooperatives, and 2.8 million pounds in other sales. This record low volume was due to a 45 percent cut in the effective quota, combined with substantial non-auction burley tobacco sales under contract. These two factors combined to reduce the level of burley tobacco sold at auction to the lowest volume level since the establishment of the quota system in 1938. In contrast, prices were at record levels; the average price of $1.95 per pound and $195.40 per hundred pounds is the highest ever recorded.

In Kentucky, 169.3 million pounds of burley tobacco were sold on the auction floor for the 2000 crop year, representing 68.8 percent of total auction sales, as shown in Table 3. This is compared to the 1999 crop year where Kentucky sold 413.6 million pounds of burley tobacco, representing 71.2 percent of total auction sales of 580.7 million pounds, a 59.1 percent decline in Kentucky burley tobacco auction sales from 1999 to 2000. This decline in auction sales is attributable, however, to a significant drop in quota from 1999 to 2000 as well as contract sales.

The effective quota for 2001 is 368 million pounds. As shown in Table 4, this is a .2 percent increase from the 2000 effective quota of 367.4 million pounds, but a 58.2 percent decline from the 1997 effective quota of 879.8 million pounds. The basic quota increased from 247.4 million pounds in 2000 to 332 million pounds in 2001.

TABLE 4
Burley Tobacco Quota *(in millions of pounds)*

Crop Year	Basic Quota	Change	Effective Quota	Change
1997	704.5	11.2%	879.8	21.5%
1998	637.8	-9.5%	860.0	-2.3%
1999	452.9	-29.0%	690.1	-19.8%
2000	247.4	-45.4%	367.4	-46.8%
2001	332.0	34.2%	368.0	.2%
Total change in Quota 1997-2001	-372.5	-52.9%	-511.8	-58.2%

- Change represents the percentage change in quota from the previous year.
- 1997 was selected as a base year because it is the peak year of burley production.
- Basic quota is the amount of burley tobacco the U.S. government will let farmers grow. Effective quota is the basic quota amount plus any pounds farmers were allowed to sell in previous years but didn't because of crop problems or other reasons.

This increase was a direct result of having the 1999 crop declared a disaster and forgiving the 1999 loan on the pool stocks. If this had not occurred, the effective quota reduction for the 2001 quota would have been much greater, because the manufacturer's purchase intentions declined again from 242.5 million pounds in 2000 to 225 million pounds in 2001 and there was only a small amount of quota carried forward from 2000 that could be applied to the 2001 effective quota.

Increased Move to Contracting in 2001

The constriction of the supply of tobacco due to the quota cuts for 2001 and a large amount of tobacco being contracted has in the short run pushed other companies into contracting. Additionally, for various other reasons, contracting is very attractive to the tobacco companies, both cigarette manufacturers and high volume leaf dealers, namely because it offers them greater control over the quality and quantity of tobacco they purchase. As indicated in a Southern Legislative Conference (SLC) report on contracting in tobacco, contracting may very well end up, in the long-run, to be the preferred marketing method for most domestically-purchased tobacco. However, smaller companies, such as low to medium volume leaf dealers that purchase tobacco specifically for export, or small cigarette manufacturers may be harmed by a total shift to contract production. A move toward total contract sales of burley tobacco may force a centralization of tobacco companies because it favors the larger companies.

The current auction market provides the small companies with the opportunity to pick and choose among grades. If the burley tobacco market shifted to totally contracted marketing, these smaller 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 scenario is that the smaller companies would contract with a leaf dealer that contracts with farmers for all grades and then act as a clearinghouse for tobacco, thus raising the cost to the smaller companies with very little of the increase in cost going back to the tobacco producers. The clearinghouse method of reselling is common in most other tobacco-producing countries.

For the 2001 burley tobacco growing season, all of the major cigarette manufacturers and most of the smaller cigarette manufacturers and leaf dealers are contracting, compared to just one manufacturer contracting in 2000. For producers, as of September 2001, 63 percent of the producers beltwide have indicated that they will market their tobacco via direct contract for the 2001 season, as opposed to approximately 26 percent in 2000. This is shown in Table 5.

TABLE 5
Total Beltwide Burley Tobacco Sales *(in millions of pounds)*

	1999	2000	2001
Total Sales Volume	580.7	333.4	368.0 (2001 effective quota)
Contract Sales	None	87.5	Not Available
Auction Sales	580.7	245.9	Not Available
Percentage of Sales sold via Contract	None	26%	63% designated

- The sales volume figure for 2001 is the total burley effective quota for the year, since sales figures will not be final until early 2002.
- The percentage of sales figure for 2001 is the percentage of pounds that have been designated to be sold under contract at the end of the designation period reported to the USDA and FSA as of September, 2001.

All four major cigarette manufacturing companies are either directly contracting with producers for tobacco or contracting with a major large volume leaf dealer that contracts directly with producers. Three of the major cigarette manufacturers are setting up receiving stations and contracting directly with producers. Three major tobacco leaf dealers are directly contracting with farmers to provide this tobacco to the major cigarette manufacturers and the smaller manufacturers, plus the export and smaller leaf dealers. A preliminary look at these contracts, prices, and grades by experts at the University of Kentucky College of Agriculture indicates that although most companies are following the example of the contract from the 2000 growing season, there are some differences, particularly in the prices paid or not paid for certain grades that are being sought.

Conclusion

The 2001 tobacco growing season in Kentucky will be a watershed year in which it likely will be determined whether a dual auction/contracting marketing system can survive, according to many experts and the SLC report on tobacco contracting. According to new Kentucky FSA director, Jeff Hall, if burley tobacco contracting rates reach anticipated levels, the number of auction warehouses and sales days could be cut in half if not more from the 2000 season. As reported earlier, as of September 2001, 63 percent of the producers have indicated that they will market their tobacco via direct contract for the 2001 season. The Burley Auction Warehouse Association anticipates widespread auction warehouse closures after actual auction sale dates, places, and pounds become known beltwide. The executive director of the Burley Auction Warehouse Association said that at least 24 warehouses have closed since last season, most of them in Kentucky. Four auction markets, Glasgow, Greensburg, Louisville, and Russellville, will not be open this year, with others anticipated to follow.

These developments, coming after years of quota cuts, put growers and warehouses alike in 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. It is not known if this drive to increase efficiencies will doom the federal price support program, or force long anticipated changes in the federal program, such as a buyout or changes in the quota system.

As the Tobacco Task Force indicated in the first part of this report, there seem to be clear advantages of having two healthy systems, for at least a transition period, 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 may be necessary that there be some supplemental support for the federal program such as support for the grading system in order to protect its viability.

If there are adequate protections, Kentucky tobacco farmers likely will weather this turmoil and emerge financially sound and productive, according to the SLC report on tobacco contracting. Tobacco will likely continue to be produced in Kentucky, albeit at a lower level than in the past. What has become clear is that the future of domestic tobacco production is dependent on more than the manner in which the leaf is marketed. According to a tobacco expert at the University of Kentucky College of Agriculture and the SLC tobacco contracting report, drops in domestic consumption, shifts in global cigarette productions, 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.

Kentucky's 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. However, this transition period of all burley tobacco being sold on the auction floor to a majority of burley tobacco being sold by direct contracts is a time of considerable uncertainty. Continued monitoring of issues surrounding tobacco contracting and seeking to understand the anxiety and provide support to Kentucky tobacco farmers and quota holders in this time of transition should be the utmost priority for the Tobacco Task Force.

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APPENDICES

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B. Philip Morris Contract and Price Schedule

C. Written Testimony of Tobacco Groups, Companies, and Other Organizations Involved in Tobacco Contracting

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A printed copy of this document, including appendices, is available upon request to Margaret Bingham in the Publications Office at 502.564.8100, ext.884 or Margaret.Bingham@LRC.STATE.KY.US. Researchers needing further information should contact Brad Wellons at 502.564.8100.