

U.S. Tobacco Situation and Outlook

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Cigarette Market

The cigarette market, particularly in developed countries, is characterized by increased regulation. In the U.S. the Food and Drug Administration (FDA) Center for Tobacco Products (CTP) slowly moves forward with implementation of the 2009 Family Smoking and Protection Act. All characterizing flavors have been banned except Menthol. Study of the menthol issue continues with new funding for research studies despite a Tobacco Products Scientific Advisory Committee (TPSAC) study recommending menthol be banned. Over 100 harmful constituents have been identified in cigarettes by FDA with 20 being flagged for testing. Proposed graphic labels have been ditched after courts ruled in favor of the industry in a suit that cited the graphic labels as a violation of the free speech amendment. FDA will develop new proposed labeling requirements. Draft guidance has been produced for approval of modified risk tobacco products. With an annual budget of over \$450 million the CTP has proceeded with inspections of tobacco manufacturing facilities and with \$53 million in research funding for 14 Tobacco Centers of Regulatory Science. With much study and few conclusions for implementation, a primary effect of the CTP on the market for cigarettes has been increased uncertainty about what and when future regulatory actions may be implemented. One impact of this uncertainty at the farm level is that manufacturers are more reluctant to hold inventories of tobacco due to the uncertainty of what levels of identified constituents may be allowed in the future. Lower inventories may be a factor in the increased volatility of farm level tobacco prices.

U.S. cigarette consumption continues its steady decline. Total consumption was 286 billion cigarettes in 2012, down from 299 billion in 2011, and down from the peak of 633 billion in 1981. Per capita consumption was 920 cigarettes, down from 969 in 2011, and down from the peak of 2,905 in 1976. According to the *Tax Burden on Tobacco* (vol. 47, 2012) the average retail price for cigarettes in the U.S. was \$5.64 per pack in November 2012. Federal taxes are \$1.01 per pack and the weighted average state excise tax was \$1.21 per pack in 2012. Federal tax collections on cigarettes were \$14.5 billion and state tax collections were \$17 billion in (FY) 2012. After large increases in state and federal excise tax rates on tobacco products last decade, the increase in tax rates has slowed in recent years. As of this year, only 10 states have not adopted statewide bans on smoking. Of those adopting statewide bans 28 have enacted bans on smoking in all inside public places.

The emerging e-cigarette market has potential to dramatically reshape the U.S. cigarette market. Some analysts think e-cigarette consumption could surpass consumption of traditional cigarettes in the U.S. within a decade. The stance taken by FDA (currently uncertain) on e-cigarettes will be a critical factor in the outcome of this market. Traditional cigarette manufacturers are now investing heavily in this sector. Currently, some in industry have indicated that extracting nicotine for e-cigarettes may require more tobacco than required for comparable smoking quantities of traditional cigarettes. However, should this sector continue to grow, incentives will be to create tobacco varieties specifically for nicotine extraction. As such optimism is not warranted that growth in e-cigarettes will increase demand for traditional tobacco production. Just the opposite could occur.

In the European Union revision is underway of the Tobacco Products Directive (TPD) that regulates tobacco products. The EU Parliament voted on the revisions October 8, 2013. Revisions include banning all characterizing flavors in cigarettes, requiring health warnings that cover 65% of the cigarette package, stricter internet sales and increased tracking and traceability. Flavorings will be phased out

over five years except Menthol which will be phased out over eight years. The revisions passed by Parliament are less strict than the package proposed and adopted by the EU Council. The proposed revisions would have required 75% of the cigarette package to be covered by health warnings, banned all flavorings immediately, and classified e-cigarettes with over a certain amount of nicotine as pharmaceuticals. The revisions passed by Parliament now go back to the EU Council for reconciliation. Of the 2008-2012 annual average U.S. unmanufactured tobacco exports of \$1.19 billion, \$412 million (about 34%) were exported to the EU-27. While the size of the impact of the TPD revisions is uncertain, just an 8% reduction in U.S. unmanufactured tobacco exports to the EU-27 could reduce the annual value of U.S. tobacco farm output by \$37.6 million.

The World Health Organization's (WHO) Framework Convention on Tobacco Control (FCTC) entails recommendations similar to the FDA and TPD in a treaty to which 177 countries are parties. While enforcement and adoption of the recommendations vary among party countries, the FCTC is leading to wider global adoption of smoking and tobacco manufacturing restrictions, anti-smoking education, and increased taxation.

China and other southeast Asia countries are notable exceptions to declining cigarette consumption in much of the world, particularly developed countries. Cigarette production in China has increased from 1.875 trillion in 2004 to 2.445 trillion in 2011 and is projected to continue to increase at a rate of about 3% per year. In particular increased production of upper end premium cigarettes seems to mean that Chinese cigarette producers want more flavor style tobacco like that produced in the U.S. Evidence of this increased demand for flavor style tobacco is that China National Tobacco Corporation made substantial investments in tobacco procurement in Zimbabwe in recent years and this year opened procurement offices in the U.S. in North Carolina.

Flue-Cured Production and Market

Excellent quality but lower yields characterize the 2013 U.S. flue-cured tobacco crop. Yields were much lower than expected due to a very wet growing season. Average yield for 2013 is forecast by USDA to be 2,024 pounds per acre, down from 2,296 pounds per acre in 2012. The quality of the crop is excellent. Record high prices are evidence of the short supply but high quality of the crop. Average price per pound may exceed \$2.15 per pound. Production is estimated by USDA at 439 million pounds down from 473 million pounds produced in 2012 and down from early season expectations for a near 500 million pounds of production for 2013. Production and industry experts seem to concur that actual crop size for 2013 is less than the most recent USDA estimates.

Preseason prices offered in contracts, while not as high as actual prices paid, were up from those offered in 2012 in an attempt to increase U.S. flue-cured production for 2013. The wet season caused some acreage to be abandoned but most of the reduction in crop size was due to lower yields due to excessive rain. A weather devastated 2011 U.S. crop, lack-luster Brazilian production, and increased demand from China resulted in short global supplies of flavor style flue-cured tobacco. Hopes were that increased U.S. acreage for 2013 would alleviate the tight supply conditions. Harvested acreage for 2013 is forecast by USDA to be 216,000 acres, up from 206,000 acres in 2012.

Given a smaller 2013 U.S. flue-cured crop than expected, buyers will attempt to increase 2014 production in the southern hemisphere. With the Brazil crop planted hopes are for a 1.4 billion pound crop for 2014. Universal Leaf Tobacco Company estimates the 2013 crop from Brazil at 1.34 billion pounds. Zimbabwe produced about 364 million pounds of good quality flue-cured in 2013. According to the Zimbabwe Tobacco Association the average price per pound for the 2013 season was \$1.67 per pound, up slightly from the 2012 season. Should the very tight supply situation be alleviated by larger, good quality flue-cured crops in Brazil and Zimbabwe in 2014, then 2014 U.S. prices likely will fall back below \$2 per pound. With very tight supplies and lower tobacco inventories held by many manufacturers, contract prices offered in early 2014 will be very sensitive to estimates of the crop size

and quality of the southern hemisphere flavor style producers. Given the continued declining demand for tobacco products in the U.S. and European Union, tobacco prices will also be very dependent on continued robust demand from China.

Table 1: U.S. Flue-Cured Tobacco Production, 2004 to 2013, in million pounds.

	Florida	Georgia	North Carolina	South Carolina	Virginia	U.S. Total
2004	9.8	46.7	344	63.4	57.6	521.5
2005	5.5	27.8	273.9	39.9	33.7	380.8
2006	2.9	30.1	324.0	48.3	42.0	447.2
2007	n/a	39.8	376.8	46.1	41.0	503.8
2008	n/a	33.6	384.7	39.9	41.0	499.2
2009	n/a	28.0	417.6	38.8	42.0	526.4
2010	n/a	27.4	348.6	36.0	39.9	451.9
2011	n/a	26.8	248.0	26.3	43.5	344.6
2012	n/a	22.5	377.2	25.2	48.0	472.9
2013	n/a	29.2	340.0	17.1	52.9	439.2

(Source: USDA, NASS, Crop Production Report, September 2013)

Export estimates are not yet available for the 2012 crop, but should be up from the 2011 crop estimate of 248 million pounds. With a small, low quality crop in 2011 domestic use was down substantially at 159 million pounds, down from 210 million from the 2010 crop. Prior to the 2010 and 2011 crops, both adversely affected by weather, exports had been on an upward trend. This trend is expected to have resumed with the good quality 2012 and 2013 crops. Domestic use has been on a downward trend since 2004. It may recover from the very low level of the 2011 crop, but not to pre-2011 crop levels. The upward trend in exports has been driven by more competitively priced U.S. tobacco since the buyout and increased global demand for flavor style flue-cured tobacco due mainly to the growing Chinese market. The downward trend in domestic use is driven by declining U.S. cigarette consumption and factors leading to less tobacco being used per cigarette produced in the U.S.

Table 2: Flue-Cured Tobacco Production, Stocks, Supply and Disappearance (farm sales wt. million lb)

Marketing Year	Beginning Stocks	Production	Total Supply	Ending Stocks	Total Use	Exports	Domestic Use
2004-2005	822.8	499.3	1,322.2	796.0	526.2	188.6	337.6
2005-2006	796.0	380.9	1,176.9	604.0	572.8	258.4	314.4
2006-2007	604.0	446.5	1,050.5	493.2	557.3	247.0	310.3
2007-2008	493.2	503.8	997.0	396.8	600.2	305.0	295.3
2008-2009	396.8	499.2	896.0	360.3	535.6	304.2	231.5
2009-2010	360.3	525.4	885.7	398.8	486.9	303.1	183.8
2010-2011	398.8	451.9	850.7	381.9	468.8	258.9	209.9
2011-2012	381.9	344.6	726.5	319.2	407.3	248.4	158.9

(Sources: USDA-AMS Tobacco Stocks as of April 1, 2013. USDA-NASS. USDA-FAS GATS)

Burley Production and Market

The U.S. and global markets for burley are following similar trends displayed by the U.S. flue-cured market – tight supplies entering 2013, challenging growing conditions this year, and expectations of a strong marketing season. Following a decline of more than 25% last year in world burley production, tobacco buyers were hopeful that Kentucky and surrounding states would supply more burley in 2013. World burley production likely rebounded in 2013, but most of the growth occurred in lower quality/filler-style markets. U.S. burley contract volume and acres planted were likely up this year, but excessive summer rains in some areas destroyed acreage and likely caused yields to be below average.

According to the latest available USDA crop report, U.S. burley production in 2013 is forecast at 201.7 million pounds, only 2% below last year's official crop size. However, many production specialists and industry officials believe this estimate to be optimistic, with a crop more likely in the 180-190 million pound range. Harvested U.S. burley acres are projected to be up 4,000 acres in Kentucky, but only 1,200 acres higher beltwide. Average burley yields across the belt are estimated by USDA at 1,966 lbs/acre versus last year's 2,021 lbs/acre. Consequently, global burley supplies of quality/full flavor burley remain very tight as U.S. producers prepare for the upcoming 2013-2014 marketing season.

Table 3: U.S. Burley Tobacco Production, 2004 to 2013, in million pounds.

	Kentucky	Tennessee	Pennsylvania	North Carolina	Others	U.S. Total
2004	206.7	46.1	n/a	6.6	32.8	292.2
2005	143.5	34.0	4.8	5.0	16.1	203.4
2006	153.3	30.8	11.6	6.6	15.0	217.1
2007	154.0	20.8	10.8	6.6	15.2	207.4
2008	147.0	24.7	9.9	5.6	14.3	201.5
2009	161.3	26.9	9.4	6.3	11.0	214.9
2010	140.4	24.9	10.1	4.0	8.2	187.6
2011	128.0	22.5	11.0	3.4	7.4	172.3
2012	151.7	29.0	11.5	4.0	8.5	204.7
2013	156.0	21.8	12.8	4.5	6.6	201.7

(Source: USDA, NASS, Crop Production Report, September 2013)

U.S. burley disappearance (domestic use plus exports) in recent years has stabilized to around 210 to 220 million pounds. Tight U.S. burley supplies have limited export opportunities in recent years despite favorable exchange rates. However, the value of the U.S. dollar has been increasing of late which does raise some concern over U.S. price competitiveness in international markets. Domestic use continues to be hindered by declining domestic consumption, but the rate of decline in U.S. cigarette consumption/production has fallen over the past couple of years, which has supported domestic burley demand amidst tight world burley supplies. Plus, it is unclear if anticipated FDA regulation on tobacco products has adversely impacted import leaf demand.

A 2013 U.S. burley crop expected to be near 200 million pounds (which remains debatable at the present time) will likely be less than the level needed by tobacco manufacturers and dealers and should create a seller's market for this upcoming marketing season. Early contract prices schedules indicated market prices for top quality U.S. burley would average around \$2.00/lb, but the current supply/demand balance could once again lead to some price adjustments this fall/winter, especially if an excellent quality crop materializes during the curing season and anticipated marketings fall well below 200 million pounds.

While the market appears favorable for 2013, it is important to realize that increasing short-term market opportunities and higher prices for U.S. burley growers are being driven more by tight supplies and not from overall demand expansion. Based on the anticipated supply/demand balance, look for U.S. burley contract volume requests to potentially increase again in 2014 (subject to 2013 marketings). A multitude of long-term uncertainties remain including immigration reform, future crop insurance changes, U.S./global tobacco regulations and the impact of a small, but growing market for harm reduction tobacco products.

Of particular concern for burley long-term are the potential implications of flavoring/additive bans currently being debated in Europe and around the world. Various non-tobacco ingredients are added in the manufacturing process to offset some of the taste characteristics evolving from incorporating burley in blended cigarettes. Presently, it is unclear whether full flavor burley tobaccos (like U.S. burley) would have any advantage over lower quality/filler style burley tobaccos if a ban was adopted in a particular market. Besides affecting the overall demand for burley, other regulatory actions to influence

manufacturing processes could ultimately impact grower production practices leading to lower burley yields and profits. Also, a growing market for electronic cigarettes could have a significant adverse impact on U.S. burley demand – both domestically and globally. So despite some short-term optimism, U.S. burley producers have a multitude of concerning factors limiting expansion and reinvestment in future burley production.

Table 4: Burley Tobacco Production, Stocks, Supply and Disappearance (farm sales weight million lb)

Marketing Year	Beginning Stocks	Production	Total Supply	Ending Stocks	Total Use	Exports	Domestic Use
2004-2005	540.0	280.1	820.1	492.6	327.5	227.6	99.9
2005-2006	492.6	203.4	696.0	403.4	292.6	200.4	92.3
2006-2007	403.4	217.1	620.5	296.2	324.4	259.8	64.6
2007-2008	296.2	207.4	503.6	256.2	247.4	192.1	55.3
2008-2009	256.2	201.5	457.7	239.2	218.5	140.0	78.5
2009-2010	239.2	214.9	454.0	237.7	216.4	116.0	100.4
2010-2011	237.7	187.6	425.3	208.2	217.1	118.8	98.3
2011-2012	208.2	172.3	380.4	170.7	209.8	103.4	106.4

(Source USDA-AMS Tobacco Stocks as of April 1, 2013)

Dark Tobacco Situation and Outlook

U.S. dark tobacco growers continue to benefit from growing domestic snuff sales and limited foreign competition. U.S. snuff consumption has been increasing annually since the mid 1980s on the heels of new product introductions, successful marketing programs, smoking restrictions, and perceived lower health risks comparable to combustible tobacco products. Domestic snuff sales were up 3.3% in 2012, with a 4% growth rate during the first half of 2013 – slightly below annual growth patterns experienced over the past decade. On the supply side, dark tobacco acres have been adjusting the past few years in response to an excessive crop produced in 2008 when new companies entered the marketplace. After several years of acreage adjustment, U.S. dark tobacco acreage was up around 2,000 acres this year, with USDA projecting a 10% larger dark tobacco crop in 2013 compared to last year (although some industry officials project smaller increases). Based on contract prices, look for 2013 dark fire-cured prices for quality leaf to be in the neighborhood of \$2.60/lb and near \$2.25-2.30/lb for dark air-cured. Despite continued product sales growth, a noticeable larger 2013 crop may cause the industry to reevaluate additional acreage expansion in 2014. Nevertheless, the outlook for the U.S. dark tobacco growing sector remains very favorable given projected sales growth for smokeless tobacco products in the United States.