

# U.S. Flue-Cured Tobacco Situation and Outlook: November 2013

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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 Draft guidance has been produced for approval of modified risk tobacco products.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 graphic health warnings that cover 65% of the cigarette package, stricter internet sales and increased tracking and traceability. Except for menthol, characterizing flavorings will be phased out over three years. Menthol 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 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**

A very wet 2013 growing season led to lower yields and some abandoned acreage. Average yield for 2013 is forecast by USDA to be 2,024 pounds per acre, down from 2,296 pounds per acre in 2012. Record high prices are evidence of the short supply of the crop. Average price per pound may exceed \$2.15. 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. Many industry and production experts think the USDA estimate is too optimistic and that the 2013 is less than 439 million pounds.

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. 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 flue-cured in 2013. According to the Zimbabwe Tobacco Association the average price per pound for the 2013 season was \$1.67, 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*, August 2013)

Export estimates are not yet available for the 2012 crop, but exports 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 better 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. Whether

or not exports continue their upward trend depends largely on whether increased demand from China will offset potentially declining demand from Europe and increased supply from Zimbabwe. 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 weight 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 July 1, 2012. USDA-NASS. USDA-FAS GATS)