Tobacco
Quota

FAX COVER SHEET

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Office of the Under Secretary
Farm and Foreign Agricultural Services
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Date: 12/4/98

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PAGES: 6
(including cover)

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COMMENTS:

USDA

INFORMATIONAL MEMORANDUM FOR THE SECRETARY

United States
Department of
Agriculture

Farm and Foreign
Agricultural
Services

Farm Service
Agency

1400 Independence
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Washington, DC
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THROUGH: August Schumacher, Jr.
Under Secretary for Farm and
Foreign Agricultural Services

FROM: Keith Kelly
Administrator KEITH KELLY DEC 3 1998

SUBJECT: Drop in 1999 Crop Year Purchase Intentions for Flue-Cured Tobacco

ISSUE:

To provide an update on the drop in cigarette manufacturers' purchase intentions, its effect on establishing the 1999 flue-cured quota, and the options available in establishing the quota.

DISCUSSION:

The national flue-cured tobacco marketing quota is based on 3 components: 1) purchase intentions submitted by domestic cigarette manufacturers, 2) three-year average of unmanufactured flue-cured exports, and 3) reserve supply level.

The 5 major cigarette manufacturers were required to submit purchase intentions for the 1999 crop year by December 1. The Department (USDA) must announce the 1999 national marketing quota by December 15 based on the 3-part formula. The Secretary must announce the quota within a 97 percent to 103 percent range of the 3-part formula total.

The purchase intentions submitted by manufacturers on December 1 totaled 327 million pounds, a decline of 127.6 million pounds or 28 percent from the 1998 level. The 1999 purchase intentions are the second lowest since this method for establishing quotas was initiated in 1986.

Reasons for Decline:

Purchase intentions for leaf tobacco reveal manufacturers perceived needs for leaf used in cigarettes during the next 2 or 3 years. With settlements between states attorneys general and the cigarette manufacturers totaling around $250 billion, cigarette manufacturers have already announced wholesale price increases equivalent to 45 cents per pack, or a 30 percent increase. This will result in a 10 to 15 percent decline in domestic cigarette consumption with further price increases and consumption declines likely.

In addition to the decline in domestic cigarette consumption, cigarette exports have declined during the last two years. With depressed economic conditions in Southeast Asia and some other countries, cigarette export prospects have weakened. Furthermore, many countries prefer to manufacture cigarettes locally rather than import them. This trend is further reducing cigarette export potential.

Other Quota Factors:

Leaf tobacco exports are also down. Leaf exports in 1997/98 totaled 334 million pounds, the lowest level since 1942. The three year average of exports for 1996/97, 1997/98, and a projected optimistic figure of 340 million pounds for 1998/99 gives a figure of 355 million pounds for the 3-year average of exports for use in the 3-part formula for setting the flue-cured national marketing quota.

The third part of the quota formula, reserve stocks, are in excess supply. The Flue-Cured Tobacco Cooperative Stabilization Corporation (Stabilization) currently holds 265 million pound of flue-cured (green-weight) tobacco. The reserve supply formula calls for 121 million pounds (15 percent of last year's basic quota--807.6 million pounds).

Of the 3 components of the quota formula, only the reserve stock figure can change before the quota is set on December 15. The Office of General Counsel has ruled that cigarette manufacturers cannot revise the purchase intentions they submitted on December 1. Several inquiries have been made concerning this possibility. The export number is also firm.

Consequently, the only component that can be changed to modify the quota number is the uncommitted loan stocks number. Currently, that part of the formula is a minus 144 million pounds. Without any loan stock sales the quota would be set as follows:

Purchase Intentions:	327 million pounds
Average Exports (3 years)	355 million pounds
Reserve Stock Adjustment	- 144 million pounds
TOTAL	538 million pounds

The worst case scenario would be a flue-cured national marketing quota of 538 million --or a 33 percent reduction from the 1998 crop year.

If all 265 million pounds of loan stocks are sold, the loan stock adjustment would become plus (+) 121 million pounds and the quota would total 803 million pounds, almost the same as last year. With the Secretary's 3 percent adjustment, the quota could conceivably increase from last year level.

Realistically, the most optimistic quota scenario is not likely to occur. However, there is a very good possibility that some cigarette manufacturers understated purchase intentions and will need to buy from loan stocks. The amount of purchases will likely depend on the amount that loan stocks are discounted.

It might be realistic, although optimistic, to assume that understatements of needs and discounted prices would result in sales of 100 to 125 million pounds of loan stock tobacco. These assumed sales, together with the 3 percent Secretarial discretion could boost the quota to between 660 million and 705 million pounds — 13 to 18 percent below a year earlier. However, to affect the 1999 quota level, the sales would have to occur by December 15, 1998.

No-Net-Cost Analysis:

As of July 31, 1998, Stabilization's debt, including principal and interest, equaled approximately $550 million on the 1997 and 1998 crop inventories. After excluding approximately $66 million for projected losses on the 1994 buyout, which covered the 1990 through 1993 crops, the no-net-cost account for Stabilization would total approximately $158 million to be used to offset losses on current 1997 and 1998 inventories of 231 million pounds (dry weight) and projected 1999 crop loan receipts. Stabilization has proposed an 18 percent reduction in current list prices to the industry without any positive response. The industry has requested a 25 percent discount from current list prices. An 18 percent reduction from current Association list prices for the 1997 crop would result in a no-net-cost assessment level of approximately 4 cents per pound for the 1999 crop year.

SUMMARY:

U.S. cigarette consumption is expected to decline 10 percent or more during the next year. Cigarette exports will do well to hold their own and leaf exports are down because of economic problems in importing countries and large world supplies of leaf tobacco. This translates into reduced demand for U.S. leaf. Although there are good prospects for some loan stock sales, it seems almost inevitable that supply and demand conditions mandate at least a double-digit cut in the 1999 flue-cured tobacco quota.

You are invited to a

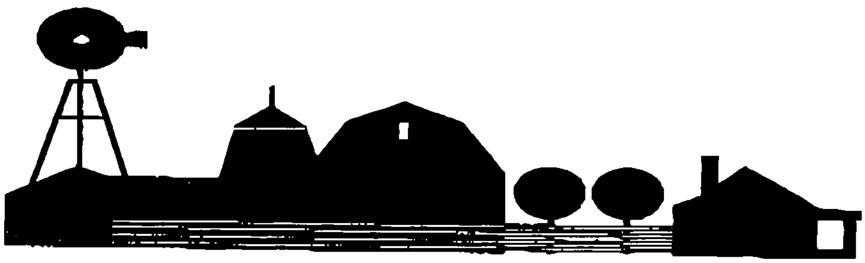
Retirement Reception

Tom Freedman

In Honor Of

DALLAS R. SMITH

Deputy Under Secretary for Farm and
Foreign Agricultural Services
Office of the Secretary
U. S. Department of Agriculture



Monday, December 14, 1998
4:00 - 6:00 PM

Executive Dining Room
3rd Floor, Jamie L. Whitten Building
(Jefferson Drive Entrance)
1400 Independence Avenue, SW
Washington, D. C.

RSVP to Jackie Burrello or Kathy Blythe
at 202-720-7107
by Monday, December 7, 1998