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IS THE MARLBORO MAN ABOUT TO GUN DOWN HIS RIVALS?

Congress is setting the stage for a Western movie-style shoot-out. People will disagree about which heads deserve the black hats; however, when the shooting starts, investors also may make a killing. One post-Labor Day piece of unfinished legislative business is what to do about tobacco farmers. As a result of federal action, demoralized tobacco farmers have watched their incomes fall by more than 50 percent over the past seven years. Under current rules, things can only get worse. For years, they have tried to interest Washington in a bailout – with no success. This year, their advocates have leverage. Farmers have better than a fifty percent chance of walking away from this duel with their pockets bulging. Depending on the specific plan Congress adopts, Altria will be the large winner while other tobacco manufacturers lose, or manufacturers and farmers will all share the loot.

When Government Help Hurts

The federal government has supported tobacco prices since the Great Depression, using supply restriction and support prices. The Executive Branch and Congress each play a role. The Secretary of Agriculture controls supply and domestic price, and Congress endeavors to assure that the tobacco program does not cost the taxpayers money, while agreeing to be the buyer of last resort if the government's price attracts too few buyers. Every year, the U.S. Department of Agriculture (USDA) decides how much American tobacco should be grown, then parcels out the right to grow this quantity in pro rata fashion to holders of tobacco "quotas." The Secretary of Agriculture deliberately sets quotas low. This makes American grown tobacco sufficiently scarce that the USDA usually avoids having to purchase excess inventory. In 2004, he set an 501 million pound quota for flue-cured tobacco so that it sells for more than its support price of $1.69 per pound at farm auctions. He also set the 2004 quota for burley tobacco at 331 million pounds, calculating this amount will sell for more than the support price of $1.873 per pound.

The federal government sometimes becomes the last resort purchaser because American tobacco costs almost twice as much as foreign tobacco – even when sold in the U.S. Smokers enjoy the quality of American tobacco, but not its price. The problem is that foreign grown tobacco has improved considerably in quality over the last decade, and it can be processed into the form needed by manufacturers, and arrive in the U.S. at just $1.75 per pound while the manufacturing-ready price for American tobacco is $3.10 per pound. Since foreign-grown tobacco has no import restrictions, U.S. manufacturers have increasingly turned to foreign grown leaf to blend with U.S. grown leaf. Today, 45 percent of tobacco consumed by Americans is grown in the United States. In 1990, 70 percent was grown here. This is why tobacco farmers are hurting, why they fear for the future, and why they want a bailout. Both the House and Senate have offered them ones, with very different implications, not for farmers who will happily accept either plan, but for their customers, cigarette manufacturers.

The House Plan: Everybody Wins But Taxpayers

Under the House passed bailout, the Depression-era control tobacco program is scrapped. The government no longer agrees to buy tobacco as a buyer of last resort if prices fall below support levels because there will no longer be a support price. Furthermore, if someone wants to grow tobacco, he can. He doesn't need a quota to do so. On many farms that have historically grown tobacco, output will double within a growing season. It is only because the quota system restricts supply that these farms produce so little tobacco. The House bill could cause tobacco stalks to sprout in new areas of the U.S., such as Texas and California.

Freed from Washington manufactured rules, agricultural efficiency and global competition would determine where tobacco is grown in the U.S. and what price it will fetch in the marketplace. It would not be surprising if output tripled in just a few years, leaping from 831 million pounds to 2,400 million pounds. It also wouldn't be surprising if the price of raw leaf, fresh from the farm, fell by 60 cents, from $1.96 per pound to $1.36 per pound, as the supply of the world's most popular tobacco goes from being artificially scarce to trebling in size. Manufacturers anywhere in the world will win twice, once by paying less for American tobacco and a second time by paying less for competing foreign tobacco. A glut of American tobacco on the world market will lead, not only to lower prices for American leaf, but also for product sold by foreign producers. USDA economist Bob Tarczy has estimated that a "quota buyout" will cut U.S. companies costs by $15 billion over fourteen years, or about $1 billion per year!

Acreage that once yielded over $3,000 annually in revenue now would produce only $2,000; however, if prices fall by one-third, profits fall by much more. For this, tobacco farmers want to be paid. The House-passed bill awards $8 per pound to quota holders, who often rent their quotas to others, and another $4 per pound to farmers that actually produce tobacco. The cost of buying out existing stakeholders is $9.6 billion, which would be paid out over five years. It would be paid from the general Treasury. If this version of reform prevails, Altria should send the Marlboro Man to buy a round of drinks for the industry's shareholders, including those owning Reynolds American and Lorillard, then invite other domestic tobacco manufacturers and tobacco farmers up to the bar, too. They will all raise a glass to toast the taxpayer for his generosity.

The Senate Plan: the Marlboro Man Gets Mean

The Senate-passed version creates winners and losers, reflecting the power of anti-smoking forces. As in the House bill, price supports disappear and the federal government neither restricts output nor buys excessively high priced tobacco that cannot find buyers. However, anti-smoking forces object to the possibility that tobacco will be grown on farms that previously planted other crops. Therefore, the Senate bill allows only farms that now grow tobacco to do so in the future; these farms will be "licensed." Output might revert back to 1998 levels, double current production, or even head higher, but it cannot spread to new areas. Anti-smoking forces also are in no mood to give the U.S. tobacco industry $1 billion a year in lower production costs free of charge. In return for this gift, they think that tobacco companies should foot the bill for buying out tobacco quota holders and farmers. The Senate bill provides a more generous $12 billion to them over ten years.

Even more troubling to some tobacco manufacturers is that the Senate bill gives the federal government expanded legal authority to regulate tobacco. Here are some of the specific powers that the executive branch would acquire:

- Limit the amount of tar, nicotine, and other dangerous components in tobacco products
- Limit advertising that children are likely to see
- Prohibit the use of "low-tar" or "light" in ads unless the FDA approves
- Require the disclosure of all harmful ingredients in tobacco
- Require warning labels to equal 30 percent of tobacco labels and be placed on the front
- Require magazine advertising to be in black and white
- Ban flavored cigarettes, except for menthol

What surprises some is that Altria has endorsed the Senate bill enthusiastically while Reynolds American and Lorillard have condemned it strongly. Here is what each has said:

- *"Altria Group and our domestic tobacco company, Philip Morris USA, enthusiastically endorse passage of a final FSC/ETI bill that contains the DeWine/Kennedy FDA proposal in its entirety, and we will strongly oppose any and all amendments to this language during the upcoming House/Senate Conference Committee,"* said Steven C. Parrish, Senior Vice President Corporate Affairs, Altria Group

- *"It's a case where only the biggest get bigger. And they know that,"* said Steve Watson, Vice President for External Relations with Lorillard.

- The proposal *"... will have absolutely devastating consequence for tobacco manufacturers, their employees, wholesale and retail customers, and communities,"* asserts Tommy Payne, Executive Vice President for R.J. Reynolds.

Altria likes the Senate bill because it gains more in the reduced cost of post-buyout tobacco than it loses in having to pay U.S. tobacco quota holders and farmers. Altria has a 50 percent share of the U.S. domestic market and therefore can be expected to pay 50 percent of the buyout costs, or $6 billion over ten years. Like other companies, it probably will try to pass on buyout costs, projected at 6 cents per pack, to its customers. However, Altria manufactures and ships *four times* as many cigarettes from its widespread overseas operations than it does to U.S. consumers. Thus, what is most important about the buyout to Altria is that the *world* price of high quality tobacco comes down. Altria may walk off with as much as 75 percent of one billion dollars in annual U.S. tobacco companies' world-wide annual savings, which, if capitalized at 5 percent, is worth $15 billion – while paying only 50 percent of the buyout costs, or $6 billion over ten years.

Altria's major U.S. competitors – Reynolds American and Lorillard, a subsidiary of Loew's – are hurt by the Senate bill. They would pay about $4.8 billion of buyout costs over ten years, but the likely expected value of reduced tobacco costs is worth approximately $4 billion to them. It hasn't escaped their notice that FDA regulation brings with it higher costs, which affects 100 percent of their businesses because they operate only in the U.S., but only 20 percent of Altria's global empire. The Marlboro Man is pointing FDA-loaded bullets at all competitors, and will shoot to kill.

Election Year Politics: Favorable

Does it matter this fall what people in North Carolina, Kentucky, Georgia, and South Carolina think, since more than 70 percent of U.S. tobacco is grown in just these four states? The answer is "yes." While the Bush campaign expects to capture the electoral votes from Kentucky, Georgia, and South Carolina, it also wants to pocket North Carolina's electoral votes without having to expend resources to do so. North Carolina was expected to slip quietly into Bush's column until North Carolina's Democrat Senator, John Edwards, became John Kerry's running mate. It's no longer a sure thing. One way to court trouble would be to antagonize North Carolina's farmers who already have seen their tobacco revenues fall by 50 percent. As a result, the Bush Administration has reversed its earlier position against a buyout.

Over in the Senate, Majority Leader Frist (R-TN) has neither failed to notice that his own farmers would be helped by a buyout, nor that the GOP's tenuous 51-49 grip on the Senate would be tightened if Congressman Burr (R-NC5) defeats Erskine Bowles in their hard fought contest to succeed Edwards in the Senate. Bumper stickers in the Tar Heel state read, "No Buyout, No Burr." A buyout also could help the Senate GOP hold onto the upper body in South Carolina where Inez Tannebaum (D) is running slightly behind Congressman DeMint (R) in their race to replace Senator Hollings (D). Minority Leader Tom Daschle (D-SD) knows Senate control could be at stake and supports a buyout. This is one reason why the"consensus plan," joining a buyout with tobacco companies payments and FDA regulation, cleared the Senate by a vote of 78 to 15.

House Republican leaders are thinking about hotly competitive races in Kentucky's third and fourth districts, along with similar struggles in Georgia's third and twelfth districts. Up to four seats could be at stake if the GOP lets tobacco farmers down.

A Procedural Complication

At the moment, negotiations over the tobacco buyout are taking place as part of HR 4520, a broad corporate tax reform bill, because House and Senate leaders offered their differing buyout and regulatory plans as amendments to this tax bill on the House and Senate floors. If the ensuring Conference agreement on this tax bill fails to clear Congress for any reason, then the tobacco buyout could be a casualty. Alternatively, if a tobacco buyout compromise is reached, it could be added as an amendment to a non-controversial piece of legislation.

Overall, the odds are better than 50/50 that Altria and tobacco farmers get generous presents from their Democrat and Republican Congressional friends before the 108th Congress quits for the year. It's time to think about venturing into Marlboro Country.

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