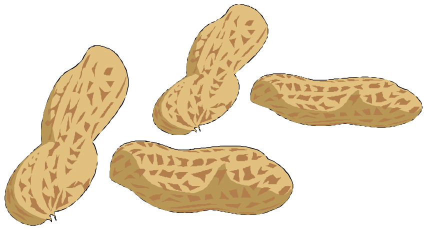
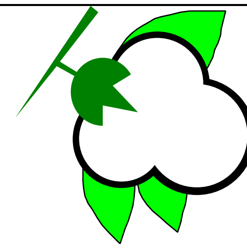




Risk Management Strategies for Peanuts, Cotton and Tobacco Under New Farm Legislation

Dixie Watts Reaves
Ag & Applied Economics
Virginia Tech

Dixie Watts Reaves
Associate Professor
Department of Agricultural and Applied Economics
Virginia Tech
November 15, 1996

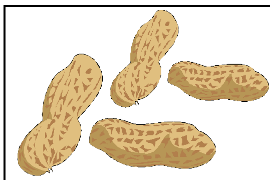
I want to share with you some background from my own personal experiences. I have had experience with tobacco for a number of years, and for the past couple of years, I've been doing some work in the cotton and peanut areas. I am also going to draw on some expertise from other individuals and share with you their predictions and comments. Some of what I will say today is common sense. You already know it quite well, but I hope to provide some implications and suggestions that might be helpful to you as you try to operate under the new farm legislation.

I will talk about each of the commodities in turn. I will give you some perspective of where we stand in Virginia relative to the national picture, talk about the actual changes in legislation that have taken place, talk about what the impacts of that legislative change might be, and then offer a few suggestions as to what you might do to handle some of the increased risk that you are going to be seeing in the market place.

PEANUTS

Peanuts were the fifth largest crop in farm cash receipts in Virginia with $62 million in 1995, and we harvested 89,000 acres (Slide 1). At our meeting today, we are almost in the heart of the peanut producing area: Southampton, Isle of Wight, Suffolk, Sussex, Greensville, and Surry. These are the top six peanut producing counties. We found out a few days ago that acreage declined to about 76,000 acres for 1996. Virginia, producing 207 million pounds of peanuts in 1995, is the fifth largest peanut producing state in the U.S. behind Georgia, Texas, Alabama, and North Carolina.

Slide 1.

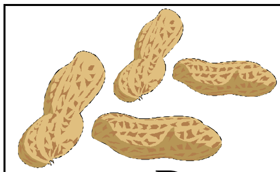


Importance of Peanuts to Virginia

- Fifth highest crop in cash receipts in VA
  * 62 M in cash receipts in 1995
- 89,000 acres harvested in 1995
  * Southampton, Isle of Wight, Suffolk, Sussex, Greensville, Surry top 6 counties
- VA is the fifth largest peanut-producing state, behind GA, TX, AL & NC
  * 207 M lbs. in 1995

The peanut program was one of the programs impacted by FAIR, the new Farm Bill. There were five major factors that are stated as having led to this change in the peanut program (Slide 2). We have seen decreasing domestic demand since 1989. We have seen, over time, an over-supply in quota peanuts. The government purchased quota peanuts last year at $678 a ton, was not able to sell them as higher priced edible nuts, and had to sell them in the lower value crush market. We have also seen high domestic prices relative to world prices. Yes, you can argue that we do have higher quality nuts. But the argument at the world level is, "Is the difference in quality great enough to justify the difference in the price that we see between the world and U.S. peanut prices?" There have also been complaints about the high cost of the government program. The price support levels and the cost to the government to run the peanut program are other incentives for change. Finally, with changes in trade agreements with the General Agreement on Tariffs and Trade (GATT) and the North American Free Trade Agreement (NAFTA), we see some differences in the way that we operate in this world market. These five factors helped drive some of the changes in the peanut program that we saw in the new legislation.

Slide 2.

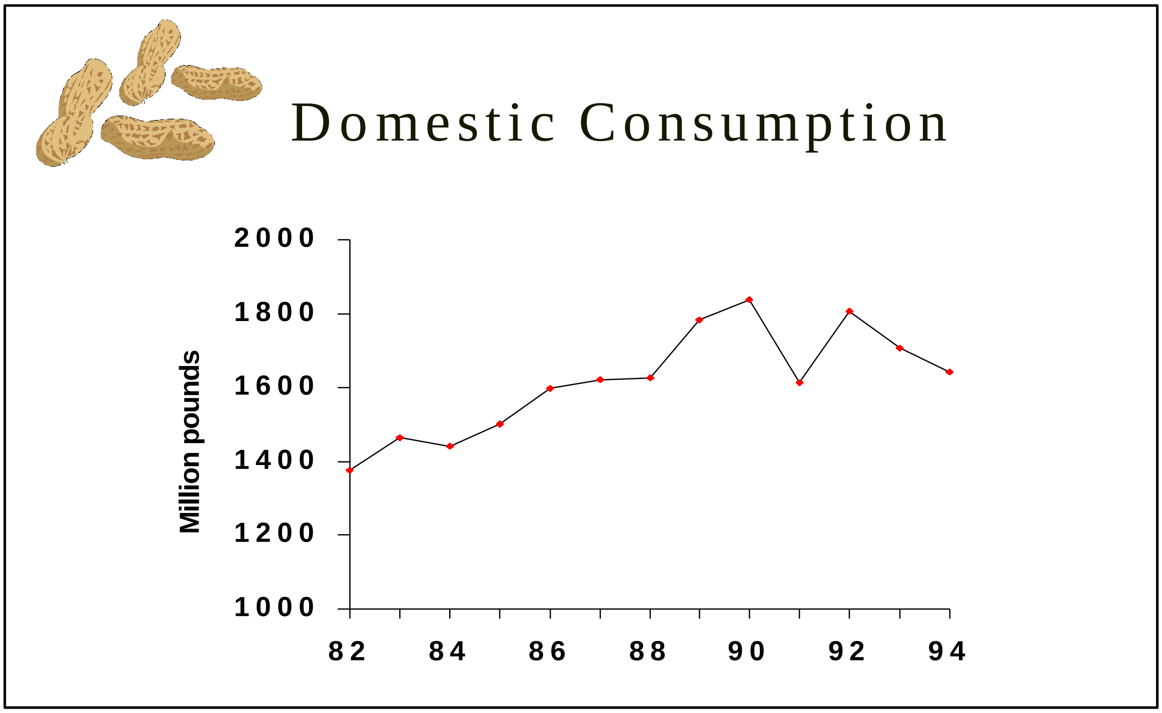


Factors for Change

- Decreasing domestic demand
- Oversupply of quota peanuts
- High domestic price relative to world price (but for high quality peanuts)
- High costs of government program
- Changes in trade agreements

Slide 3 shows domestic consumption since 1982. About 1989 domestic consumption peaked, and since then we have had a continual decline. Some of the decline is because people do not think nuts are as healthy as other snack foods. Whether that is true or not is another issue, but it is what the consumers perceive. If consumers are on a “health kick,” perceive that peanuts are not a healthy snack, and move their consumption to other commodities, we have a job to do to change consumers’ perceptions. That decline in domestic consumption was one of the driving forces behind the changes in the peanut program, along with the other four factors I just mentioned.

Slide 3.



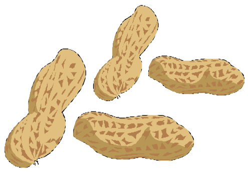
What were the major program changes that we saw in peanuts (Slide 4)? We saw changes in the price support level. The loan rate went from $678 down to $610, a decrease of 10 percent from the 1995 level, and was frozen at this level for the life of the program. The price support level used to increase up to 5 percent with increased costs of production, but that is no longer true. Over the next seven years, you will not get any increases in your price support level based on increasing production costs. You will have even more of a cost-price squeeze than you had before as your input costs can rise while your price support level remains the same.

Another change that we saw is in quota determination. There is no longer a quota floor. The quota is determined based on use estimates, supply estimates, and ending stocks. Under previous programs, there was a floor set so that regardless of how low consumption might have dropped, the quota could not go below a certain level. There were a couple of years during the last five when quota actually should have been lower than it was, but the floor held it up. That floor is no longer there: quota can continue to decline if domestic consumption continues to decline.

There were changes in quota eligibility. There are more restrictions now. Public entities must get rid of their quota. If you live out-of-state, you either have to be actively involved in peanut production or you have to get rid of your quota.

Undermarketings are now eliminated (Slide 5). If you do not produce your quota in one year, you do not get to carry it over and sell it next year if you have extra peanuts. No more undermarketings; no carryover for your quota under the new Farm Bill.

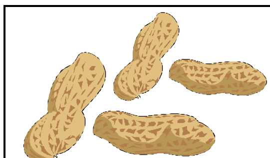
Slide 4.



Major Program Changes

- Price support
  - * Loan rate decreased 10% from '95
    - * From $678 to $610
  - * Frozen for life of the program
    - * No increases for higher costs of prod'n
- Quota determination
  - * No longer have a quota floor
- Quota eligibility
  - * Public entities and out-of-state non-producing owners must divest themselves of their quota

Slide 5.



More Program Changes

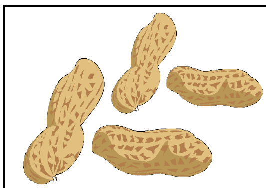
- Undermarketings eliminated
  - * No carry-over quota
- Quota sales
  - * Less restrictive
- Cost of program
  - * No-net-cost to the government
- Marketing assessment
  - * 0.6% of national average loan rate in 1996
  - * 0.65% in 1997 - 2002
  - * 0.55% for handlers

Quota sales are now a little bit less restrictive, especially the fall sales. You may now sell within the state, not just within your own county.

The cost of the program has become like the tobacco program: no-net-cost to the government. You are now paying marketing assessment fees and other fees to cover the cost of that program so that the government is no longer bearing the cost. Part of that cost is in a marketing assessment, which in 1996 will be 0.6 percent of the national average loan rate. That amount is going to increase to 0.65 percent in 1997 and continue through 2002. Handlers are paying 0.55 percent.

What are the implications of these changes (Slide 6)? First and most obvious, you have lower quota prices, down from $678 to $610. You can also expect lower quota quantities. There are a couple of reasons to expect that: there is no longer the quota floor, and we have seen declining domestic consumption. Under GATT we are going to see more imports coming into the U.S. We need our domestic demand to increase to offset those additional imports since we have a quota based on use and ending stocks. That is something that we are going to have to work on. It is not something that is going to happen; it is something that has to be actively sought. With your output prices coming down, if your input prices are steady or rising, you are going to see declining net returns per acre. However, even with this decrease in net returns, it is expected that peanuts are probably going to remain one of the best uses for the land where we have quota-owner-producers. If you actually own your quota, you are probably not going to find better alternative uses for that land.

Slide 6.

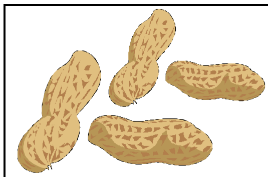


Implications

- Lower prices
- Expect lower quotas
    - * No quota floor
    - * Under GATT, expect more imports
    - * Would need domestic demand to increase to offset imports
- With no decrease in input costs, net returns per acre will decline
- Even with decrease, peanuts are probably best use of the land for quota owner-producer

What if you are not one of those quota owners (Slide 7)? What if you are a quota renter instead? An average of two-thirds of the peanut quota is rented. A large number of producers are renting their quota. Is it going to remain profitable for those of you who are renting to stay in peanut production? There are a few things that you are going to have to consider. Can quota renters continue to afford current lease rates? As you look at quota rental rates, you would assume that these rates take into account the net return that you hope to get from producing quota peanuts. If you have a declining price support level and declining net returns, the return from that land the quota is tied to is going down. Is it reasonable, is it "fair," to continue paying the same rental rates when the net returns you are expecting are actually declining? With lower price supports, should quota-lease rates decline as well? That has implications for both the renters and the owners. There are individuals who are depending on that quota rental income for retirement. They are planning for their futures, and they are going to be impacted if the rental rates go down. Can the renters continue to pay those rental rates as quota prices decline? That is an issue that I hope to work on in the future. If I see you again in a future audience, I hope to have some more specific answers to those questions

Slide 7.

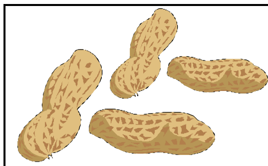


Implications

- But an average of 2/3 of peanut quota is rented
- * Can quota renters continue to afford current lease rates?
- * With lower price supports, should quota lease rates decline?
- * What are the implications for both renters and owners?

There is some good news for Virginia when it comes to peanut production (Slide 8). First of all, the Virginia-North Carolina production region has averaged higher net returns than other peanut producing regions. Jim Pease showed some comparisons of net returns for the southeast versus the U.S. We actually have those numbers broken out for Carolina-Virginia peanut production. Compared to the rest of the nation, Virginia has a comparative advantage adjusting to that new legislation because we have traditionally had higher net returns than any other region. We are going to fare better in peanuts than some other peanut producing regions in the nation. Furthermore, Virginia is definitely known for its high quality in-shell peanuts. We have a reputation for quality.

Slide 8.



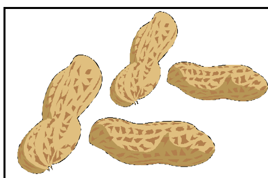
The Good News for Virginia

- The Virginia-North Carolina production region has averaged higher net returns than other peanut-producing regions
- Virginia is known for high quality in-shell peanuts

Suggestions

What is it that we can do (Slide 9)? Some of these suggestions are going to be common sense, and you have already considered them. Hopefully, hearing them stated will put it all into perspective for you.

Slide 9.



What to Do?

- Look closely at your farm budget. How can input costs be reduced?
- * Utilize extension resources
- * Apply pesticides at economic thresholds
- * Consider optimal seeding rate
- *Improve crop rotation practices
- *Negotiate rental rates

Look closely at your farm budget. If you are going to see your output price declining, what can you do to try to minimize your input costs? Utilize your extension resources. You have extension agents and specialists who are working with researchers at Virginia Tech to try to find more efficient ways to get things done. Take advantage of those resources. Let them help you determine where you might be able to reduce costs. Apply pesticides at economic thresholds. It is much easier to spray after "X" number of days, no matter how many bugs are out there. We need to be more careful and more concerned now about where the actual threshold is for spraying. If having some level of pests is not going to decrease our yield or our quality, it does not hurt to let them stay. You have to make sure that you are only spraying at those economic thresholds where spraying is merited.

Consider optimal seeding rates. We might have been using high rates in the past, but could we cut back on seeding rates and still get the same yields that we have been getting all along? We might cut some of our input costs there.

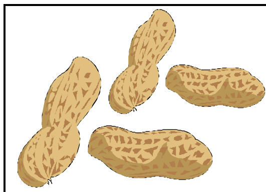
Improve crop rotation practices. As we see declines in our quota, we will have more land available for planting the remaining quota. Take advantage of that. The lengthy rotation periods are better for us in terms of pest and disease pressures. We need to improve our crop rotation practices to the degree that we are able.

Finally, negotiate rental rates. I think that is one of the key issues that is probably going to be a contentious one. It is, however, something that must be dealt with. Rent is one of our input costs that can be negotiated. It is up to producers and land owners to get together to negotiate those rates.

What else can you do (Slide 10)? Be wary of large capital investments. We have had a profitable enterprise in peanuts. It is easy to want to buy new equipment and invest in new technology. Be wary of making capital investments at this point in time until we see how much these prices are actually going to decline and what kind of quota changes are going to occur. You also have to be concerned about your debt repayment schedules. They were probably scheduled based on the price support level for peanuts that you have come to expect over time. All of a sudden, it is not there any more. Be aware of how that change is going to impact not only your debt repayment schedule but also your ability to repay those debts.

Finally, we need to be concerned about the decline in domestic consumption. Individually you probably can do little, but a grower organization might be able to have an impact. What kinds of programs can we undertake to encourage a resurgence in domestic demand for peanuts? Be attuned to consumers' perceptions. It is easy for folks to look from the outside in, to say negative things about pesticide use and other cultural practices. Be aware of consumers' perceptions of your commodity. Continue to practice the good land stewardship you have always used so that there is nothing negative that anyone can focus on. It is possible to have some kind of scare in the peanut industry similar to the alar scare in the apple industry. We do not need any kind of negative perceptions.

Slide 10.



What Else to Do?

- Be wary of large capital investments
- Be aware of impacts of lower net returns on ability to repay debt
- What can be done to expand domestic demand for peanuts?
- Be aware of consumer perception
- Continue to be good stewards of the land

COTTON

Cotton is the sixth largest cash crop in Virginia at $48.2 million in farm receipts as of 1995 (Slide 11). We had 106,000 acres in 1995. We heard recently that it is down to about 102,000 this year. Our top five producing counties will look very familiar: Southampton, Suffolk, Isle of Wight, Greensville, and Sussex. As you know, peanut and cotton production go hand-in-hand. When you look at Virginia compared to national cotton production, we are not a big player. We rank 13 out of 17; we had 137,000 bales in 1995—a very small percentage of national production, but we were definitely increasing production until this past year. Slide 12 gives you an idea of what the acreage trend looks like. It goes from 1990 to 1996. We had this really, really large increase early on, and this past year we had a slight decrease, but there was a decrease nationally as well.

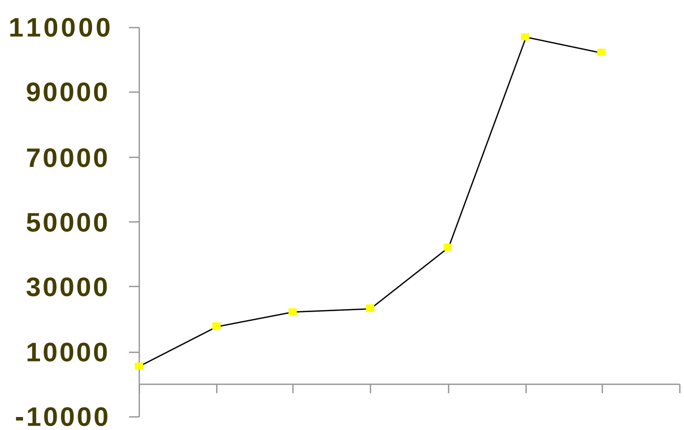
Slide 11.

Importance of Cotton to Virginia

- 6th largest crop in cash receipts in VA
  * $48.2 M in 1995
- 106,000 acres in 1995
  * Southampton, Suffolk, Isle of Wight, Greensville & Sussex top 5 counties
- Of 17 producing states, VA ranks 13
  * 137,000 bales in 1995

Slide 12.

Acreage Trend



What changes were there for cotton in the new Farm Bill (Slide 13)? You have heard reference to the new production flexibility contracts. You now have the ability to plant whatever it is you want to plant. You receive a declining payment over 7 years based on 85 percent of your contract acres. If you look at the national expenditures on these production flexibility contract payments over the 7-year period of the Farm Bill, cotton is getting just 11.6 percent. Here in Virginia, 99.8 percent of you have already enrolled your eligible acreage; you have already taken advantage of this opportunity. Another change is that the marketing assistance loan rate has gone to $0.52.

Slide 13.

Changes

- Production flexibility contracts
- Farmer receives declining payment over 7 yrs.
  - * Payment based on 85% of contract acres
  - * Cotton receives 11.63% of total payments
  - * 99.8% of VA's acreage is enrolled
- Marketing assistance loan rate = $0.52

I would like to talk to you about a case study of Southampton County farmers that Wes Alexander in Southampton County helped me conduct last year. We saw the dramatic increase in acreage over a five-year period in Virginia and questioned what was happening. What caused so many producers to go to cotton production? Traditionally, agricultural producers tend to be rather slow to change, making gradual adjustments. With cotton acreage, however, it was more like an explosion. What combination of factors led to that increase? What implications do these increases have for what research and extension might be able to offer those producers? If some of the factors that drove producers to go into cotton production in such large numbers change, can we expect a return to the lower acreage?

To answer these questions, we conducted a case study in Southampton last December (Slide 14). We surveyed 77 Southampton producers. *Because these producers were not a random sample of producers, the results are not necessarily generalizable to the whole county, and certainly not to the whole state*. But they can help us understand some of the rationale for change.

Slide 14.

December 1995
Southampton County Case Study

- 77 Southampton County farmers surveyed
- Average cotton acreage increased from 62 acres in ‘93 to 324 acres in ‘95
- 75% of acreage was grown on rented land
- In the same period, corn acreage declined from 180 acres to 30 acres
- On average, producers had been growing cotton for 2.5 years

Average cotton acreage increased from 62 acres in 1993 to 324 acres in 1995. In those three production years, we saw a dramatic increase in average acreage for these producers surveyed. Seventy-five percent of that acreage was grown on rented land. Again, we have the renter/owner situation that we have in peanuts. In that same period, the average number of corn acres declined from 180 acres to 30 acres. Approximately one-third of the production that went into cotton came from corn acreage. On average, those producers surveyed had been growing cotton for just 2 ½ years.

We asked the farmers what factors were important to them in making the decision to produce cotton (Slide 15). Of course, there are some really obvious ones that would come to mind. First and foremost, it was a good opportunity for increased profit. Cotton prices were very high. It was almost a situation of "I’ve got to get in on this, these prices are almost too good to be true." But for those folks in the peanut producing counties, cotton also provided a very good rotation crop with their peanuts. The second reason most often given for choosing to go into cotton production was the low prices for the traditionally grown commodities. Thus, prices, in addition to the rotation, drove people into cotton production. Producers also felt that there was a significant demand for cotton. When they looked at their local community, they felt that there was a very dependable price for cotton. They had convenient market locations—a lot of gin facilities right there, readily available to them. All of these factors together provided positive motivations for entering cotton production.

Slide 15.

Factors Important in Decision to Go Into Cotton

- Good opportunity for increased profit
- Fits well in rotation with peanuts
- Low prices of traditionally grown commodities
- Significant demand
- Dependable price
- Convenient location of markets

There are some additional results from the case study that provide interesting insights (Slide 16). These are percentages based on the 77 producers responding to our survey. *Remember they cannot be generalized to the rest of the county or to the state.*

- 53 percent of them obtained a loan to start cotton production. You now have that debt repayment issue that was mentioned a few moments ago with peanuts that now cotton producers have to be aware of.
- 37 percent owned their own cotton picker as of December 1995. I am sure that percentage is quite a bit higher now because I know that a lot of farmers have invested in their own equipment over the past year.
- 59 percent of the folks were farming in some kind of partnership or corporation as opposed to individually.
- 70 percent of those who did not have harvesters were satisfied with the timing of harvest. One of the concerns with your harvesting is that if you do not harvest on time, you get decreases in quality. Yet, most of those farmers who had to depend on custom harvest were pretty happy with the timing of their harvest.
- 86 percent of those that we surveyed saw the future prospect for the cotton market for them as either very good or good. The producers in this particular case study were very optimistic at the end of 1995 about what the cotton market held for them.

Slide 16.

More Case Study Results

- 53% obtained a loan to start cotton activities
- 37% owned a cotton picker
- 59% farmed in a partnership or corporation
- 70% of those without harvesters were satisfied with the timing of their harvest
- 86% saw the future prospect of the cotton market for them as very good or good

That gives you an idea of what one study found about the motivation and reasons for going into cotton production and how the farmers surveyed saw the future.

What is going to happen now with the changes in the farm legislation relating to cotton? What can we expect to take place (Slide 17)? These predictions are from Don Shurley, agricultural economist in Georgia. In the United States, as a whole, you can expect cotton acreage to continue to decline over the next few years. Some of this lost acreage will go back into corn and soybeans. Now that we have the freedom of planting flexibility under the new legislation, people can choose which commodities are going to offer them the highest prices. Given what you have just heard from David Kenyon, I am not sure that traditional commodities are going to be particularly good, but you might see some of the acreage that moved into cotton shifting back into these other, more traditional commodities.

In Virginia, however, I think that we can expect our acreage to be fairly stable. My prediction for Virginia, especially in the peanut producing area, is that because cotton is such a good rotation crop with peanuts we are going to maintain fairly stable acreage here in the state.

You can expect exports to decline due to increased competition. As David Kenyon pointed out, we are not the only people producing corn, soybeans, and wheat. We are not the only ones producing cotton, either. We are going to see more and more competition from the export market.

Don Shurley expects price in the $0.64 to $0.66 range from 1997 on. These are not quite the same prices that we saw that helped us make the decision to go into cotton. Those prices were much higher. We are now probably looking more at the mid-$0.60s range over the next few years.

We will continue to see some increases in yields in cotton, so that the actual net returns for cotton are going to remain fairly stable.

Slide 17.

Predictions

- In U.S., expect acreage to continue to decline
- Expect some lost acreage to go back into corn and soybeans...more planting flexibility
- Expect VA acreage to be fairly stable... good rotation crop with peanuts
- Expect exports to decline due to increased competition
- Expect price in the 64 to 66 cents range from 1997 on
- Net returns for cotton will be fairly stable

Suggestions

What kind of suggestions can we make for the cotton sector, given the changes (Slide 18)? Again, avoid highly financed, major expansion, because these high prices are temporary. We are going to see more price volatility and variability as well as declining prices. Be very wary of any further major expansions in this area. Be wary of large capital investments, and that goes right along with your expansion plans.

What are some reasonable uses for those government payments that you are going to get? You might want to reduce some of the existing debt that you undertook to go into cotton production so that when you do see this volatility, it will not put you in a repayment bind. If David Kohl were here, he would tell you to invest this windfall that you are going to be receiving in some retirement plans.

Look carefully at what each gin has to offer (Slide 19). It is very easy to simply compare price offers across gins. There is a lot more to it than price; there are all kinds of services that are involved as well. Be sure when you are making your comparisons, you are comparing apples to apples and oranges to oranges so that you do not just look at the bottom line price the gins have to offer, but at the entire package of services that they offer. **Read the fine print.** Make sure you are not getting caught off-guard by anything.

Slide 18.

Suggestions

- Avoid major expansion...high prices are temporary & prices will become more volatile
- Beware of large capital investments
- Use government payments to:
  * pay down existing debts
  * invest in retirement plans

Slide 19.

More Suggestions

- Look carefully at what each gin has to offer
  * Focus not just on price
  * Consider other services offered
  * Read the fine print
- Use forward pricing/contracting strategies
- Be concerned not just with price risk, but with revenue risk
- Pay careful attention to quality, not just quantity (yield)
  * Quality discounts can be substantial!

As with the other commodities, use whatever forward pricing and contracting opportunities you have available to you. When you can lock in a profit that is reasonable for your farm enterprise, lock it in. If it goes up a couple of cents, you have lost out on a couple of cents profit and the corresponding opportunity cost, but you are saving yourself on the downside risk. You know what your production costs are. You know how much you need to make a profit. If you see a good price, go ahead and take it. Do not wait for it to go to $1.05, because it is not going to. Lock in prices when it is profitable for you to do so. Be concerned not just with price risk, but with revenue risk as well. Price is not the only issue. Quantity and quality are other important issues. Pay careful attention to quality. If you are in the cotton industry, you know very well that quality discounts can be quite substantial. You might have a good price initially, but when you take out all your discounts for the quality differences, the result can be very different. Your returns could be negative.

In Virginia we feel that cotton is going to remain important because it is a good rotation crop in our peanut producing counties (Slide 20). Large capital investments are already in place. A number of people have already made a commitment to cotton; therefore, we are going to see people staying in it. The ginning services are well established, and we have good research and extension services in place. In spite of this decline in price support and the movement toward production flexibility contract payments, I think that we will also see a fairly stable cotton industry here in Virginia.

Slide 20.

In Virginia

- Cotton will remain fairly prevalent
- * In peanut producing counties, cotton is a good rotation crop
- * Large capital investments in place
- * Ginning services well-established
- * Research and extension in place
- Smaller percentage of government payments than in other farm areas

A smaller percentage of government payments will come to Virginia than other cotton producing areas because we have many people who have been in the program for a short period of time and who have been building up their base acres. When we look at the amount of payment that we are actually eligible to receive, the percentage is not as high as in the more traditional cotton producing areas. Virginia is not going to receive as high a percentage of those cotton payments as other states will. Nonetheless, cotton is going to remain prevalent in the state.

TOBACCO

Tobacco is one that is near and dear to my heart because it is the commodity that I grew up with (Slide 21). It is Virginia's number one cash crop. We had $175 million in farm level cash receipts in 1995, with 44,000 acres. There are three basic types of tobacco grown in Virginia: flue cured, dark fired, and burley. We also grow a little sun cured. Slide 21 shows the top counties and the type of tobacco produced in each area. I am going to focus on is flue cured tobacco.

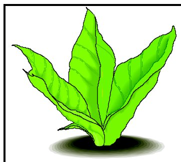
Slide 21.

Importance of Tobacco in Virginia

- Number 1 crop in cash receipts in VA
    * $175 M in 1995
- 44,000 acres in 1995
- VA ranks 5th of the 16 tobacco-producing states
    * Pittsylvania, Halifax, Mecklenburg, Brunswick, Lunenburg top flue-cured cos.
    * Scott, Washington, Lee, Russell, Smyth top burley cos.
    * Charlotte, Campbell, Brunswick, Halifax, Pittsylvania top fire-cured cos.

I recently completed a study on flue cured tobacco and its impacts on Southside Virginia (Slide 22). Southside Virginia, for the purposes of our study, was defined as a six-county region in the south-central part of the state. It encompasses the top six flue cured tobacco producing counties: Pittsylvania, Halifax, Brunswick, Mecklenburg, Lunenburg, and Charlotte. In that 6-county region, tobacco is grown on 80 percent of the farms. On average, 68 percent of all agricultural sales in this region come from tobacco. It is a region that is extremely dependent on tobacco. We looked at both tobacco production and the tobacco stemming and redrying industry. When you put those together and look at the multiplier effect of the money that is made in that region getting re-spent and re-spent through our system, it leads to $756 million in total industry output for that Southside region. It creates 6,800 jobs. For this particular region, tobacco is ubiquitous and very important.

Slide 22.



Impact on Regions

- Southside Virginia
  - * Pittsylvania, Halifax, Brunswick, Mecklenburg, Lunenburg, Charlotte
- 80% of farms in the region grow tobacco
- 68% of all agricultural sales are from tobacco
- With multiplier effects, tobacco contributes $756 M in total industry output to the region and 6800 jobs

What changes are we going to see in the tobacco program (Slide 23)? As you probably know, tobacco was not included in the FAIR Act. It comes under on-going legislation from the 1930s, so FAIR did not directly impact tobacco as a commodity the way it did cotton and peanuts. However, we can expect future change in the tobacco program. It is almost taboo to say this around tobacco producers, but I was one, my father and my uncle still are. We have to face the fact that we can expect change to take place. We cannot be afraid of it. We have to confront it, because it is going to happen to one degree or another. Why? Through FAIR we have seen reduced price support levels in other commodities. The precedent has been set to get the government out of agriculture. It is going to happen in tobacco as well. Another thing is the many pressures faced by the tobacco industry right now. There is so much negativism surrounding this industry that it is almost imminent that we are going to see change take place.

Why do we have to see change (Slide 24)? Domestic use is declining for tobacco products in Virginia and in the nation as a whole and has been for the past few years. Foreign countries are becoming more competitive. It used to be that the United States was known for high quality tobacco, and there were not many other countries that could produce high quality tobacco. That is no longer the case. Much like peanuts, price supports maintain the price of tobacco above the world price. Does that higher quality justify the higher prices we have been maintaining? The external pressures are going to drive change as well. The Food and Drug Administration regulating nicotine as a drug, the health issues, the lawsuits are all compelling us to change.

Slide 23.

Changes in the Tobacco Program

- Tobacco was not included in FAIR Act
- But expect future change to the program
- Precedent has been set in reducing price support and moving government out of ag
- Add to that the pressures faced by the tobacco industry

And change is imminent

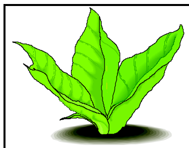
Slide 24.

Why Change?

- Domestic use is declining
- Foreign countries are becoming more competitive
- Price supports maintain price above the world price (although for higher quality)
- External pressures
  - * FDA
  - * Health issues
  - * Lawsuits

FAIR did not give us any changes. What kind of changes can we expect to see in the future (Slide 25)? In the very short run, we are going to see an increase in quota. Tobacco has a quota system similar to peanuts. In the short run, we are expecting a quota increase for the upcoming year because buyer demand was very high in 1996. We had some crop losses due to weather problems in both North Carolina and Virginia, and we ended up with low stocks at the end of the year. However, do not count on that for the long term, because this increase cannot be sustained. Quota is based on use and ending stocks. What we are going to see with the changes in domestic consumption trends is declines in quota in the long run. If you are a tobacco producer, be very wary of purchasing quota right now, because we do not know what the program is going to do and we can expect to see some change in the program over time. At the same time, since we do not know what price support levels might be maintained, be very wary of large capital investments because there is still uncertainty surrounding this particular industry.

Slide 25.



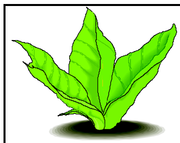
What Changes?

- In the short-run, expect quota increases
    * Buyers' demand was high in '96
    * Crop losses due to weather problems
    * Low stocks at year's end
- But don't expect increase to be sustained
- Be wary of purchasing quota
- Be wary of large capital investments

In the long term, I would expect price support levels to fall (Slide 26). We have seen it in the other commodities. I would, however, expect the program to remain in place to some degree.

There has been a lot a discussion about what should happen to the tobacco program. Should we even have a tobacco program? My thoughts are that we will have a tobacco program that will be maintained in some form. We are not sure yet what form that program is going to take. Without the program or even with some changes in the program, you can probably expect prices to fall. but look for those price decreases to be offset by acreage increases. If we no longer have the quota system and the acreage allotment system, people will be free to plant as much as they want and people will probably plant more acreage. That increase in acreage may even offset the decline in price. For the tobacco industry as a whole, you may see your revenues increase, but you will see individual producers who will be negatively impacted in this setting. In Virginia, it is possible that our acreage may not increase. Unlike cotton and peanuts, we do not necessarily have a comparative advantage in tobacco production. You might see the production shift farther south.

Slide 26.



Long-Term Expectations

- Expect price support levels to fall
- Expect program to remain in place to some degree
- Without program, prices will fall and acreage will increase, but perhaps not in VA
- Health concerns...people smoke more with lower prices
  - * Health industry may join producers in asking for continuation of the program!

You need to consider the health concerns. It is obvious that as prices for tobacco products go down, consumption of tobacco products goes up. There is an "uncommon marriage" that may be taking place. The health people, who have been so negative toward the tobacco industry for so long, may join with producers to try to keep the program in place. If the tobacco program remains and the price support levels remain high, we are going to have less consumption than if we were to take the program away, in which case prices would fall, and consumption would increase.

REAP, which is helping to sponsor this program today, has been involved in some programs and research that have looked at the tobacco industry. One of these initiatives was a recent forum in Roanoke entitled "Both Sides of the Coin" which brought these groups together to raise the awareness of the issues that each entity was facing, to try to make us appreciate each others' points of view in this tobacco issue (Slide 27).

Slide 27.

REAP/VT Involvement

- Forum: "Both Sides of the Coin"
  - * Raise awareness
- Preparation for adjustment in case of change
- * Becoming more efficient
- * Diversifying
- * Preparing for off-farm opportunities
- * Having available credit
- Educational programs to non-farmers

REAP is helping producers and state legislators think about what we might do if change were to take place. That does not say that we are advocating change; it does not say that change is something that we necessarily want to take place. But if change is going to take place, we want to be prepared for it. Even if the program were to be decreased or to go away, there will be some producers who are certainly going to stay in production. What do they need to do to become more efficient? We have worked a little bit in that area. What about diversifying? If producers find that they cannot survive on tobacco alone, or if they think there is enough uncertainty that they want to have other commodities they can produce, what products should they be going into that they can produce well and also have a market for? Everyone knows that there is no one crop that is going to replace tobacco, and no one is suggesting that there is. The question is, "What can you diversify into to supplement your tobacco income?"

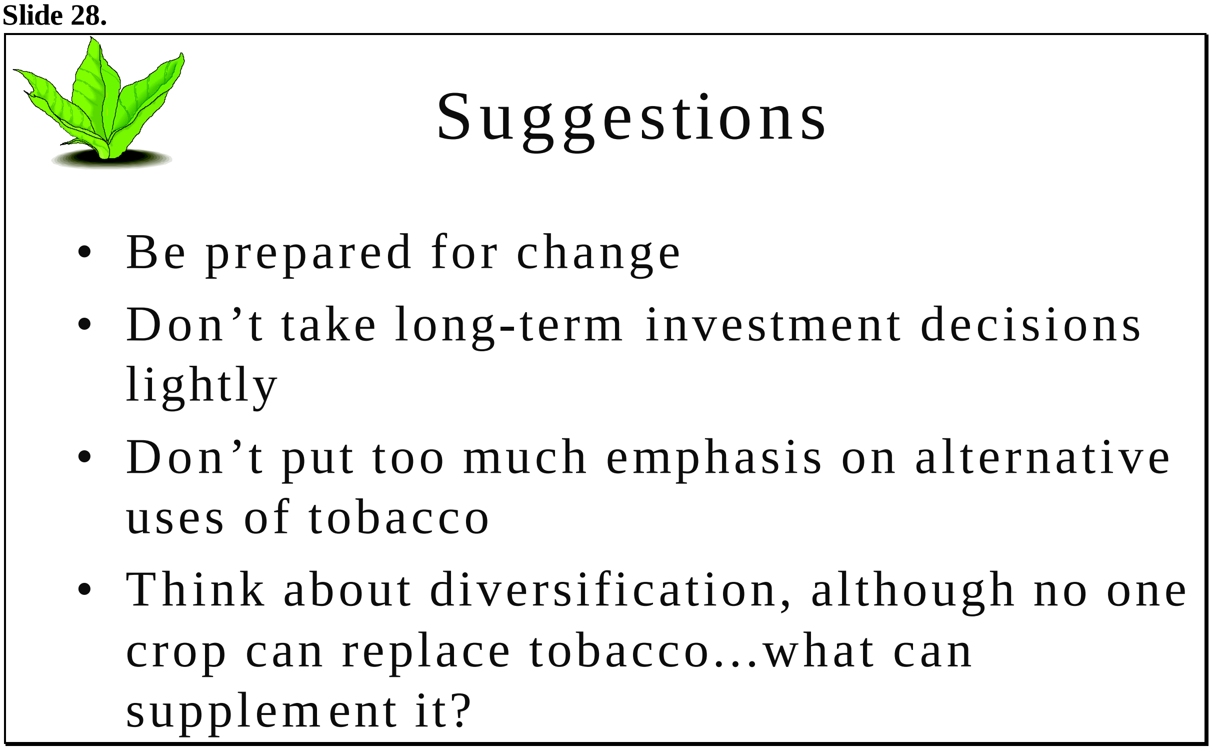
If producers decide they do not want to continue tobacco production, what other opportunities might be available for them? For those who want to go into other businesses, it is going to be critical that we have credit available for them. That is something else that REAP is working on.

Finally, we need to provide educational programs for non-farmers. If you read the headlines whenever you hear all this negativism surrounding the tobacco industry, almost all you read is stories about the tobacco manufacturers. You hear all the negativism surrounding the tobacco industry—which tends to be manufacturers in most people's minds. What we have tried to do is to make non-farm groups understand that the very basic part of this industry is producers who make their living from this industry. They are not producers who are out there trying to kill people by producing products that are unhealthy. They are producers who take pride in what they do, who have been doing this for their whole lives, from generation to generation. We are trying to help people understand that it is individual farmers and communities at the grassroots level who will be hurt most by changes in the tobacco program.

Suggestions

Be prepared for change (Slide 28). It is going to happen. We need to know what we are going to do to be prepared for it. Do not take your long-term investment decisions lightly, because we do not know yet what is going to happen with this particular industry. One thing I would caution you about is putting too much emphasis on alternative uses for tobacco. Instead of producing cigarettes, snuff, and those kinds of products with tobacco, what else can we do? Produce protein? Do not put too much weight on that. It might happen, but the acreage that it would take to support those alternative uses is going to be quite small. It is not going to be something every producer is going to be able to do. Another thing to think about is the diversification issue. We all know that there is no one thing that can replace tobacco, but there are some things that we might do to help us supplement our income if we do see changes in the tobacco program.

Slide 28.



I hope that you have been able to gain a little bit of knowledge that you might not have already had on these three commodities.

QUESTIONS

Peanuts, have you seen any figures that show quota level for the future?

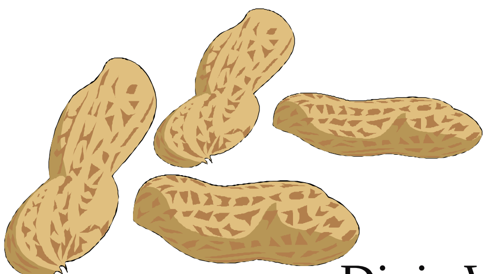
I have not seen quota predictions over the term of the program, but I am sure there is going to be a lot of work done on that.

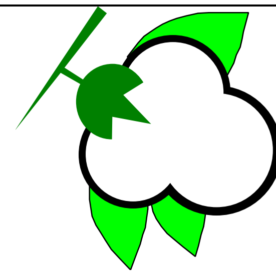
Why aren't peanuts on the futures market? Is it because the volume is so low?

No, the price is not volatile. Until now, there has been no uncertainty in prices.

Would there be an advantage to having futures?

Once you have price variability, then just as you can make use of futures to minimize your variability in other commodities, you can use futures to minimize your variability in this commodity. Up until this point the price volatility hasn't been the issue. But now that it may become an issue, futures might be advantageous.





Dixie Watts Reaves
Dept. of Ag & Applied Economics
Virginia Tech
Blacksburg, VA 24061-0401

Ph: (540)231-6153
Fax: (540)231-7417
Email: dixie@vt.edu