

“Sold, American!”

How auction markets improved the tobacco trade and why they are becoming obsolete

BY CHARLES GERENA

During the 1920s, the above phrase would frequently end the rhythmic, almost hypnotic chant of auctioneer L.A. “Speed” Riggs, indicating that American Tobacco Co. had won its bid for a farmer’s tobacco. Riggs helped growers get a good price for their crops in piles at the Liberty Warehouse in Durham, N.C. They needed all the help they could get.

In general, the tobacco plant is a tough agricultural good to appraise. Environmental conditions and cultivation techniques influence the color, texture, and size of the plant’s leaves; then the curing of leaves after they are harvested creates additional variations. Leaves picked from different positions of a stalk have unique characteristics as well. Even though grading systems attempt to capture these variables, determining the sale price of tobacco is still more art than science.

or quantity of the good cannot be substituted for another equal part or quantity. “Each lot of tobacco stands on its own,” says Prince. In contrast, “a bushel of wheat is a bushel of wheat.” This is why tobacco hasn’t been traded along with wheat and other agricultural products on a commodity exchange like the Chicago Board of Trade.

Instead, buyers and sellers have struggled for hundreds of years to create transparent, centralized markets where both sides have enough information to reach a mutually agreeable price. Until four years ago, tobacco auctions in Maryland, Virginia, and the Carolinas provided those markets. Large warehouses would be filled with the smell of the golden leaf and the singsong cries of auctioneers like Speed Riggs. They created a dynamic environment that benefited both buyers and sellers.

But in these uncertain times, a growing number of tobacco farmers and manufacturers like Philip Morris are trading the advantages of auction markets for the greater certainty of contracts. In a sense, tobacco marketing has come full circle — buyers are dealing directly with sellers as they once did hundreds of years ago.

The Golden Leaf Rush

Tobacco marketing in America started in the 1600s with frustrated colonists trying to survive in the Tidewater region of Virginia and southern Maryland. Colonists had access to Atlantic trade routes by using navigable rivers like the James to get to the Chesapeake Bay, but it didn’t help them economically because they had a hard time producing anything to trade.



A typical tobacco auction at the turn of the century brought buyers and sellers together in Richmond, Va.

“The buyers look at every lot of tobacco,” says Eldred Prince Jr., a history professor at Coastal Carolina University who has studied tobacco farming in South Carolina. “Some of them will smell it as well as look at it.”

Because many variables influence its value, tobacco isn’t fungible — one part

Then John Rolfe, the infamous husband of Pocahontas, hit pay dirt in Jamestown. The tobacco seeds that he brought from the Caribbean thrived in Virginia soil, producing leaves with a fragrant aroma when snuffed and a sweet taste when chewed. The British loved Rolfe's product and, by 1617, colonists harvested enough tobacco to export.

In the coming years, demand for America's first commercial export grew, becoming so strong that farmers devoted most of their land to tobacco rather than food. Exports from the colonies to England expanded from 20,000 pounds in 1617 to more than 40 million pounds in 1727. Production eventually expanded geographically as well, venturing westward in Virginia and southward into North Carolina and South Carolina as tobacco became more valuable than cotton or other crops and Tidewater land became depleted of nutrients.

While some growers sold their tobacco to traveling merchants, most brought their crops to market. Water was the primary means of transportation. Plantations near rivers and their tributaries had their own docks so that growers could ship tobacco leaves in heavy barrels called hogsheads, while farmers without water access rolled hogsheads over land to the nearest port or navigable body of water. In time, port towns throughout the Fifth District profited from the tobacco trade, including Alexandria, Va. and Port Tobacco, Md. on the Potomac River; Richmond and Petersburg on the James River; and Port Roanoke (Edenton), N.C. and Charleston, S.C. near the coast.

Once the farmer got his tobacco to market, a merchant would weigh and examine each hogshead, then compensate the farmer for his goods. The payment would be in the form of bartered goods or tobacco receipts, which could be used to pay wages, settle debts, and make purchases. In this way, tobacco became a form of currency.

Tobacco was so lucrative that it was hard to prevent overproduction. Periodic gluts in the tobacco market occurred, causing prices to fall and incidents of fraud to rise.

Keeping Auctions Alive

Only two warehouses in Maryland continue holding auctions for air-cured tobacco as hundreds of farmers choose to sign contracts with buyers or take advantage of a state-sponsored buyout program. Other states in the tobacco belt have more warehouses in operation than Maryland, but even their ranks are dwindling. This has prompted two farmers' cooperatives and a nonprofit organization to create alternatives to the warehouse-based auction system.

A farmer can get five cents or more per pound for selling his tobacco crop under contract, but what happens if a leaf dealer closes its receiving station before the harvest is over or rejects a farmer's crop? "If you disagree with [a buyer's decision] what opportunity do you have?" says Arnold Hamm, assistant general manager of the Flue-Cured Tobacco Cooperative Stabilization Corp. "Farmers are fearful that they will have nowhere to market their tobacco."

Only a few growers sell a portion of their tobacco directly to buyers and some through the auction system in order to keep their options open and maintain some bargaining power. But most use contracts to secure a commitment for 100 percent of their crops.

That's why the Flue-Cured Tobacco Cooperative created its own auction system in 2002 after testing the concept in 2001. The system consists of 14 marketing centers located in leased space at warehouses in Georgia, North Carolina, South Carolina, and Virginia. The Burley Tobacco Growers Cooperative

Association, which has members in West Virginia and four other states, opened its own marketing center in a former tobacco warehouse in Cynthiana, Ky. in 2002.

In western North Carolina, the state's Rural Economic Development Center has maintained an auction market for burley tobacco in the region since 2001. The center uses tobacco settlement funds to lease two warehouses in Asheville.

In each case, auctions are conducted as they were traditionally done in tobacco warehouses, with one important difference. Since the center's owners receive outside funding, they don't have to levy warehouse charges, auction fees or sales commissions.

Some warehouse owners have complained that this arrangement has given marketing centers an unfair advantage that has accelerated the demise of the auction system. In fact, several warehouse owners sued the Flue-Cured Tobacco Cooperative several years ago for violating antitrust laws. According to Hamm, business courts ruled in the co-op's favor twice and an appeal also went its way. "As a cooperative, we can use a tobacco farmer's [membership fees] to assist them in the marketing of their product."

The jury is still out on whether marketing centers will save the tobacco auction system. The Flue-Cured Tobacco Cooperative's centers have handled 5 million to 6 million pounds of tobacco each year, but that is a fraction of the total volume sold through auctions and contracts.

—CHARLES GERENA

Merchants usually loaded their purchases onto ships sight unseen. And when they did inspect a hogshead, it wasn't easy. "They would open it and try to feel down [but] there were always problems with farmers packing bad stuff at the bottom," describes James Crawford, an adjunct geography professor at Virginia Tech who has studied the Old Dominion's tobacco culture. Some planters even loaded hogsheads with bricks and rocks to increase their weight.

In 1619, Virginia lawmakers responded to these problems by passing the first laws to inspect tobacco before it was sold. If a warehouse manager found anything

awry with a hogshead, the entire contents of the barrel could be confiscated and burned. Additional laws were passed throughout the 17th century to deal with the quality issue, as well as to control the burgeoning tobacco supply. Grading standards were created, as well as inspection stations, to enforce those standards.

Still, fraud persisted and the English continued to complain about their tobacco imports from the colonies. This forced merchants to discount the price they paid to reflect their uncertainty about quality.

In 1730, Virginia established an inspection system where hogsheads of



Inspectors appraise a bale of tobacco in a warehouse in the Danville, Va., area.

tobacco had to be examined and graded by bonded inspectors at legally established warehouses before they were shipped to England. Once it was clear that the system provided a quality advantage for Virginia tobacco, Maryland followed suit in 1747 and the Carolinas in 1754.

In addition to providing locations where tobacco could be objectively evaluated, warehouses also became the centralized markets for trading the crop. Merchants and growers continued to directly trade with each other, making private deals while tobacco was being inspected. They also interacted in markets outside of the warehouse and at plantations.

Markets Discover the Auctioneer's Cry

In the early 1800s, the auction system used by the French became a popular way to trade tobacco in the Southeast.

"Some planters brought their crops to market and independently sought ... the most appealing price," wrote Billy Yeargin, a Raleigh, N.C. tobacco historian, in his master's thesis for Duke University. "Some cried the bids for their own tobacco or employed someone else, perhaps the inspector, to do the job. The intent was to establish competition among purchasers." By the 1820s, private auctioneers stepped forward to help growers get the best price for their tobacco while guaranteeing the quality of tobacco.

Just before the Civil War, businessmen in Danville, Va., opened a full-time

auction market whereby tobacco leaves were stacked into loose piles on the warehouse floor rather than sold in hogsheads. This method, which had been experimented with in Richmond and elsewhere, allowed buyers to walk along the piles and closely inspect the leaves before making a bid.

This "loose-leaf" auction system spread throughout Virginia and the Carolinas. It took longer to take hold in Maryland, according to historian Eldred Prince Jr. "Marketing was different in different tobacco regions. In the tobacco counties of southern Maryland, buyers would often go from farm to farm buying leaf."

Overall, auction markets lowered transaction costs and increased transparency. Buyers could view crops from a variety of growers in one place, and they could use the grades assigned by inspectors and their own judgment to make appropriate bids based on their quality. Farmers also benefited because they had access to a broader range of offers.

But problems with the auction system grew as tobacco manufacturers began producing cigars, pipe tobacco, and cigarettes in addition to snuff and chewing tobacco. Each product required tobacco with specific qualities, yet there was no uniform method of describing these specifications.

The grading process used by manufacturers to determine prices varied from company to company and it wasn't public knowledge. Thus, farmers still couldn't judge whether they were getting a fair deal out of the auction process. In fact, they suspected warehouse operators and tobacco buyers of stuffing their wallets with profits while leaving them struggling to make ends meet.

To gain more control over pricing, farmers tried to collectively deal with buyers outside of the auction system several times during the early 20th century. One such effort was an organization formed by farmers called the Tri-State Tobacco Growers' Cooperative.

By 1922, the cooperative managed to control half of the tobacco produced in North Carolina, South Carolina, and Virginia. According to Prince, R.J.

Reynolds bought tobacco from the cooperative, but the two largest buyers — American Tobacco and Imperial Tobacco of Great Britain — refused to deal with it.

These buyers and some warehouse owners chose to encourage defections from the cooperative, using accusations of communism, racist propaganda, and other tactics. "They dipped their arrows in venom," says Prince. The organization collapsed after five years.

Other efforts failed as well, as Pete Daniel describes in his book, *Breaking the Land: The Transformation of Cotton, Tobacco, and Rice Cultures Since 1880*. "In these reform efforts growers found traditional approaches to their problems, but attempts to implement them failed, due in part to their lack of organization and dedication but also due to concerted attacks from the interests that profited most... There was, in addition, a strong tradition of rural independence."

In recognition of the need for standards in tobacco auction markets, Congress enacted the Tobacco Inspection Act in 1935, which established the framework for development of official grading standards. The legislation also authorized the Secretary of Agriculture to designate auction markets where growers would receive mandatory inspection of their crops to determine their grade and type.

Auctions Circumvented in the Name of Certainty

Today, warehouse floors no longer have row upon row of tobacco leaves waiting for inspection. Many facilities have closed due to lack of volume.

Richard Harris, vice president of sales and operations for DIMON Inc., a Danville, Va.-based leaf dealer, gives his tally. In Virginia, North Carolina, South Carolina and two other states where flue-cured tobacco is produced, the number of warehouses shrank from 150 to 38 over the last four years. (Maryland farmers market a special type of air-cured tobacco.)

Some blame the reduced demand for American-grown tobacco among

domestic and overseas tobacco manufacturers, who are increasingly buying from cheaper foreign producers. This has been reflected in reductions in federal tobacco quotas during the last few years.

More importantly, people have been turning away from the auction system since 2000 because contractual arrangements can provide more certainty and security. About 80 percent of tobacco is sold on contract, with a farmer committing his crop to a single buyer.

By bypassing auctions, farmers know ahead of time what they will receive for each grade of tobacco when they bring their crop to a buyer's receiving station. In addition, they are immediately paid for their entire crop in one transaction and they don't have to shell out warehouse charges.

Tobacco buyers — primarily leaf dealers that make purchases for manufacturers like Philip Morris — also favor direct contracts. They collect their purchases at receiving stations instead of at warehouses where they are charged fees, and they don't have to pay an army of agents to purchase tobacco from multiple warehouses. (Of course, some of these cost savings are offset by the added expense of operating stations.) In addition, buyers get their tobacco more quickly, decreasing the amount of waste due to spoilage.

Above all, contracts can give tobacco buyers more control over their supply. According to Arnold Hamm, assistant general manager of the Flue-Cured Tobacco Cooperative Stabilization Corp., buyers are starting to sign production contracts with growers that dictate the quantity and quality of tobacco they want.

This improved communication benefits farmers as well. They are better able to match their product to the demands of the marketplace, within the limits of Mother Nature, of course.

In contrast, auction markets don't always give buyers what they want. According to a January 2001 report by agricultural economists at North Carolina State University, farmers harvest leaves from fewer parts of the stalk

than they used to. Some even harvest all the leaves with one pass through the field with no differentiation among stalk position. This is because the price they get for leaves from more desirable stalk positions aren't sufficiently high to justify the additional labor costs of selective harvesting.

In economic lingo, auction markets have been unsuccessful at transmitting incentives for quality. "The fact that cigarette manufacturers do not translate their apparent wishes for separation by stalk position into financial incentives in the marketplace seems to bear little economic logic, and has not been adequately explained by either cigarette manufacturers, leaf merchants, or auction operators," noted the N.C. State report.

Auction markets also haven't been able to give buyers enough tobacco to compete for. Some blame reductions in quotas that have shrunk the supply of tobacco too sharply. These reductions "have brought the size of the U.S. crops down by more than half in the last five years," says DIMON's Richard Harris. In response, Philip Morris, the largest purchaser of U.S. leaf, began contracting for its burley tobacco in 2000. A year later, R.J. Reynolds, Brown & Williamson, and Lorillard also started dealing directly with farmers. "When you had the largest buyer in the market doing that, others had to follow suit to protect their supply."

Buyers could have paid more for tobacco to ensure an adequate supply, since higher prices would have motivated growers to produce more. (The quota system limits this market response, although farmers can produce 3 percent above the quota and lease the right to increase production further.) Instead, they avoided the perils of price competition and locked in their supplies with individual farmers.

There are suspicions that buyers are offering higher contract prices now to lure farmers out of the auction system and its price supports. Under the federal tobacco program, a grower's crop is inspected and assigned a grade. If it fails to get an offer of at least a

penny above the price support established for that grade, the farmer can sell it to an authorized cooperative or stabilization corporation. He is paid using money borrowed from the USDA's Commodity Credit Corp., then the crop is reinspected, processed, and sold to repay the loans. In this manner, tobacco farmers are assured a minimum price for their crops.

Some farmers not only want to retain price supports, but they also want the bargaining power that warehouse-based auctions provide them. Rather than depend on supplying one buyer at one price, they want the ability to solicit multiple buyers to get a better price, especially during shortages.

Farmers also worry that direct contracting favors big agribusiness over the little guy. Large buyers of tobacco will likely sign contracts with only large-scale farms since smaller ones don't have the capacity to provide the quantities they are looking for or the technology to meet their quality standards.

Regardless of the reasons, contract buying is likely here to stay, just as it is for other agricultural goods like produce and poultry. Whether auction markets will be around is another question. The number of buyers and sellers bargaining on the warehouse floor may eventually be too small to sustain this historic means of marketing tobacco. **RF**

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