

Preliminary Evaluation of the Maryland Tobacco Authority

Recommendation: Remove from Statute due to Obsolescence

The Sunset Review Process

This evaluation was undertaken under the auspices of the Maryland Program Evaluation Act (§ 8-401 *et seq.* of the State Government Article), which establishes a process better known as “sunset review” because most of the agencies subject to review are also subject to termination. Since 1978, the Department of Legislative Services (DLS) has evaluated about 70 State agencies according to a statutory schedule as part of sunset review. The review process begins with a preliminary evaluation conducted on behalf of the Legislative Policy Committee (LPC). LPC decides whether to waive an agency from further (or full) evaluation. If waived, legislation to reauthorize the agency typically is enacted. Otherwise, a full evaluation typically is undertaken the following year.

The Maryland Tobacco Authority last underwent full evaluation as part of sunset review in 2004. That evaluation made seven recommendations, one of which was to extend the authority’s termination date by five years. During the 2005 session, the termination date of the authority was extended to July 1, 2011.

In conducting its preliminary evaluation, DLS staff interviewed staff of the Maryland Department of Agriculture (MDA) and University of Maryland Cooperative Extension. DLS staff also reviewed annual reports and the legislative history of the authority.

MDA reviewed a draft of this preliminary evaluation and provided the written comments attached at the end of this document as **Appendix 3**. Appropriate factual corrections and clarifications have been made throughout the document.

Additional context related to the tobacco industry and Maryland’s tobacco buyout program is included as **Appendices 1** and **2**, respectively.

The Maryland Tobacco Authority

The Maryland Tobacco Authority was created by Chapter 61 of 1947 to license and regulate tobacco producers, buyers, and sellers in order to alleviate the disorderly conditions surrounding the marketing of leaf tobacco in the State. Prior to 1947, State involvement in the industry was limited to State tobacco inspectors who graded tobacco and supervised the operations of the State Tobacco Warehouse. Under the provisions of Title 7 of the Agriculture Article, the authority is empowered to regulate marketing practices by licensing auction participants and overseeing auction activities. In addition to regulating the tobacco auctions, the authority may issue allocation and administrative penalties and has subpoena powers. The authority has been funded through license fees and a fee imposed on each pound of tobacco auctioned, commonly referred to as the “poundage tax.”

Statute, as amended by Chapter 530 of 2005, specifies that the authority consist of six members appointed by the Governor for three-year terms. Three of these members must be tobacco producers appointed from nominees selected by MDA. The remaining members include one person in the business of selling leaf tobacco, one person in the business of buying leaf tobacco, and one person familiar with the economics and marketing of tobacco who is selected from three nominees submitted by the Secretary of Agriculture. Typically this person has been a University of Maryland faculty member. Authority members are responsible for selecting a chairman. Each member is compensated for reasonable travel expenses in accordance with standard State travel regulations.

Currently, the authority is essentially defunct with no staff undertaking activities related to its responsibilities. In addition, no new appointments have been made since the expiration of the last member term in 2007, and the chair position is vacant. These changes have mirrored the shifts in tobacco production and auction activity. In 2006 the authority operated with two part-time contractual employees: the executive secretary and an administrative secretary. The executive secretary worked as needed through the year, with the bulk of his time devoted to the weeks of market. The work of the administrative secretary was seasonal – lasting only a couple of weeks in 2006 – with general support activities falling to MDA during the balance of the year. Prior to the 2002 market, the authority also employed a market inspector. However, the executive secretary assumed the inspector’s responsibilities in 2002 due to the significant reduction in tobacco being grown and auctioned in Maryland.

Despite its inactivity and the lack of an auction, the authority still is empowered to regulate marketing practices for leaf tobacco grown in Maryland by:

- allocating daily sales quotas and selling times during market season among commission selling agencies (warehouses);
- prescribing conditions for display of tobacco on the sales floor of any leaf warehouse;

- prescribing terms and conditions for withdrawal of baskets of leaf tobacco from the sales floor of any private warehouse;
- determining the information to be placed on the tickets of the baskets of tobacco on the sales floor of any private warehouse; and
- making inspections to determine the accuracy of weights or measures used by any commission selling agency.

However, these activities relate to tobacco auctions which are no longer held. It is no surprise then that the authority has received no formal complaints from tobacco market participants since the 2004 full evaluation.

The authority also can issue licenses to the various parties that participate in a tobacco auction, with the exception of tobacco producers. A tobacco buyer may be a representative of a tobacco company or may be an independent buyer that purchases tobacco for several tobacco companies. **Exhibit 1** compares the number of licenses issued by the authority in 1999, 2004, 2005, and 2006. According to MDA, issuing licenses to transfer buyers is the only authority function that still applies. Nevertheless, MDA notes that this function does not serve a purpose out of the context of the auction market system because the transfer buyer license was intended to establish equity between auction floor buyers and the people who bought tobacco directly from farmers. If auction floor buyers had been required to purchase a license but direct buyers had not (the transfer buyer license), then there would have been incentive to buy directly from the tobacco farmer and circumvent the tobacco auction process. Thus, the two known transfer buyers as of August 2008, Philip Morris USA and a Virginia company, are not licensed as such.

Exhibit 1
Licenses Issued by the Tobacco Authority
1999 and 2004-2006

<u>License Category</u>	<u>Number Issued</u>				<u>Fee Amount</u>
	<u>1999</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	
Commission Selling Agency (Warehouse)	5	2	2	1	\$525
Transfer Buyer	3	1	1	0	300
Sales Floor Buyer	5	4	5	3	300
Sales Floor Buyer's Agent	19	5	4	2	15
Sales Floor Seller	2	0	0	0	300
Total	34	12	12	6	

Source: Maryland Department of Agriculture

2004 Sunset Review Recognized Shifts in the Market Affecting the Authority

The 2004 sunset review made seven recommendations. Most of these recommendations were acted upon via Chapter 530 of 2005, which also required a report from the authority on the status of their implementation. **Exhibit 2** shows the recommendations, the relevant statutory change made in Chapter 530, and the MDA report on behalf of the authority about the implementation status.

Exhibit 2 2004 Sunset Review Recommendation, Statutory Change, and Implementation

<u>2004 Sunset Review Recommendation</u>	<u>Chapter 530 of 2005 Statutory Change</u>	<u>MDA Report on Implementation</u>
1. Amend statute to extend termination date from July 1, 2006 to July 1, 2011 and require a report on status of recommendations	Amended the termination date to July 1, 2011 and required the report	N/A
2. If only one tobacco warehouse remains in operation, MDA should submit legislation dissolving the authority and transferring remaining responsibilities to the department	N/A	Determines there is no need for MDA to assume the responsibilities of the authority because of the transition from the auction system to the contract purchase system
3. MDA should convene a workgroup on alternative ways of running a tobacco auction	N/A	Silent on convening a workgroup on alternative ways of running a tobacco auction
4. Amend statute to eliminate the annual compensation payment of \$750 to nongovernmental members	Eliminated the payment	N/A
5. Increase poundage tax to 25 cents per 100 pounds and consider legislation to increase licensing fees	Amended the poundage tax to 25 cents per 100 pounds	Silent on considering legislation to increase licensing fees
6. Amend statute to modify the composition of the authority as follows: reduce producer members from five to three; eliminate producer geographic and political party requirements; and change producer nominator to MDA	Amended the composition of the authority as recommended	N/A
7. Amend statute to repeal required study on tobacco production and marketing	Eliminated the study language	N/A

Source: Department of Legislative Services; Maryland Department of Agriculture

Fiscal Status of the Authority

The authority has been funded through license fees and the fee imposed on each pound of tobacco auctioned, commonly referred to as the “poundage tax.” The licensing fees are set in statute as is a ceiling on the poundage tax rate. The authority may set a lower rate for the poundage tax before the beginning of the market season, if that lower rate would be sufficient to recover its expenses. The authority may also decrease the license fees for commission selling agencies, transfer buyers, or sales floor buyers. Per Recommendation 5 of the 2004 sunset evaluation, Chapter 530 of 2005 increased the poundage tax from 20 to 25 cents per 100 pounds. However, increasing license fees, part of Recommendation 5, was not adopted by the authority because of the assumption that the auction would end in a short period of time.

In addition to the poundage tax, the authority may impose either allocation or administrative penalties, with administrative penalties paid into the general fund. Allocation penalties may be levied against sellers for exceeding their daily sales quota. However, the authority has only imposed one allocation penalty – in March 1996. No administrative penalties have been imposed.

The fiscal history of the authority is shown in **Exhibit 3**, which shows a general trend of decreasing operations. While the authority began to show a fund balance again in fiscal 2006, this was due to a lack of expenditures rather than an increase in revenues. MDA notes that \$9,000 in general funds was required in fiscal 2003 in order to cover expenses, and \$3,445 in Tobacco Trust special funds was required for the same purpose in fiscal 2004. MDA also notes that in fiscal 2004 the board members voted to discontinue their annual compensation, which anticipated the statutory change of Chapter 530 of 2005 and helped to eliminate the need for new revenue infusions. Reduced activities in fiscal 2005 and the final auction in fiscal 2006 meant that a small fund balance accrued in these years, which has been maintained due to the lack of expenditures. The authority did not auction any tobacco in fiscal 2007 and 2008, and any authority work was done voluntarily. Thus, there were no expenses in fiscal 2007 and only a \$15 postage/phone expense in fiscal 2008. MDA plans to spend down the fund balance of \$1,625 in fiscal 2009 by applying this funding to travel and other expenses related to the National Tobacco Grower Settlement Trust lawsuit. However, the Maryland General Assembly’s Assistant Attorney General advises that expenditures for the National Tobacco Grower Settlement Trust lawsuit are not within the statutory purposes of the authority because the authority was not a party to the lawsuit.

Exhibit 3
Fiscal History of the State Tobacco Authority
Fiscal 2002-2009

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
Beginning Balance	\$5,201	\$0	\$0	\$0	\$1,503	\$1,640	\$1,640	\$1,625
Revenues								
General Funds	0	9,000	0	0	0	0	0	0
Special Funds								
License Fees	5,355	2,700	2,425	3,209	1,455	0	0	0
Poundage Tax	8,052	5,178	3,237	3,675	887	0	0	0
Tobacco Trust	0	0	3,445	0	0	0	0	0
Total Revenues	\$18,608	\$16,878	\$9,107	\$6,884	\$3,845	\$1,640	\$1,640	\$1,625
Operating Costs	18,608	16,878	9,107	5,381	2,205	0	15	1,625
Total Expenses	\$18,608	\$16,878	\$9,107	\$5,381	\$2,205	\$0	\$15	\$1,625
Ending Balance	\$0	\$0	\$0	\$1,503	\$1,640	\$1,640	\$1,625	\$0

Note: Fiscal 2009 numbers are projected.

Source: Maryland Department of Agriculture

Status of Tobacco Sales in Maryland Today

Tobacco is an annual crop grown from seed. Two types of tobacco are grown in Maryland: Type 32 (Maryland) and Type 31 (burley). The types are designations given by the U.S. Department of Agriculture's classification system. Both Maryland tobacco and burley tobacco are light air-cured, which means that the whole stalks are cut and hung to dry (air-cured), as opposed to the leaves being stripped from the stalk and an external heat source being applied for curing. Cigarettes have been the traditional use of both Maryland and burley tobacco. Differences between the two include fertilizing needs, height (burley tobacco grows taller than Maryland tobacco in the field), leaf chemistry, color when ripe (burley is a lighter color than is Maryland), and brittleness when harvested.

According to the Maryland Cooperative Extension, there are approximately 125 leaf tobacco growers in Maryland today. The growers are located in Anne Arundel, Calvert, Cecil, Charles, and St. Mary's counties and are predominately Amish and Mennonite with some "English" (non-Amish or Mennonite) growers.

The 125 growers produced approximately 1.5 million pounds of burley tobacco and 25,000 pounds of Maryland tobacco in calendar 2008. These two types of tobacco are being grown under contract production directly with two companies (for instance, Philip Morris USA is buying the burley tobacco). In calendar 2006, burley tobacco growers in Maryland sent their tobacco to a Philip Morris USA buying station in New Holland, Pennsylvania, which is the center of Pennsylvania Dutch country. European leaf tobacco purchasers, who predominately bought Maryland tobacco in recent years because of its milder aroma than burley tobacco, have shifted their purchasing to places such as Brazil.

Anecdotal evidence suggests that the direct contract production purchases of burley tobacco by Philip Morris USA have resulted in a more reliable price going into the season for tobacco growers. In addition, the burley tobacco is selling for more per pound than the Maryland tobacco sold in the last few years of the auction. Burley tobacco also yields more pounds per acre than Maryland tobacco, which translates to more income for the remaining tobacco farmers in Maryland.

Tobacco Auctions and Authority Activities Have Ceased but Estimates of Direct Contract Sales of Tobacco Are Increasing

The final meeting of the authority was held November 28, 2005. At this meeting it was decided that despite the small Maryland Type 32 leaf tobacco crop the authority should continue through calendar 2006. No decision was made at the time about new appointments for the authority being made.

Subsequently, one tobacco warehouse, Farmers Warehouse, opened for three days between March 21 and 23 in 2006 for what turned out to be the last tobacco auction in Maryland. The other remaining auction warehouse, Hughesville Warehouse, remained closed. The last auction was held to sell 321,107 pounds of Maryland Type 32 leaf tobacco as shown in **Exhibit 4**. Despite the decrease in Maryland Type 32 leaf tobacco sales in Maryland, estimated tobacco production in Maryland increased between the 2005 and 2006 crop years due to the growing of burley Type 31 tobacco under direct contract.

Exhibit 4
Maryland Tobacco Production
1997-2008

Crop Production Year	<u>Net Pounds Sold</u> at Auction in Following Year	<u>Average Price per Pound</u>	<u>Total Value of Sale</u>
1997	11,985,234	\$1.72	\$20,571,581
1998	9,586,842	1.63	15,627,725
1999	9,443,245	1.66	15,656,598
2000	8,081,999	1.69	13,676,108
2001	3,577,450	1.68	6,001,427
2002	2,337,666	1.48	3,460,235
2003	1,324,496	1.73	2,297,076
2004	1,406,266	1.43	2,006,497
<u>at Auction/in Direct Contracts (Estimated)</u>			
2005	821,107 (321,107 MT/500,000 BT)	1.52	1,243,560
<u>in Direct Contracts (Estimated)</u>			
2006	1,050,000 (25,000 MT/1,025,000 BT)	1.50	1,575,000
2007	1,275,000 (25,000 MT/1,250,000 BT)	1.65	2,103,750
2008	1,525,000 (25,000 MT/1,500,000 BT)	N/A	N/A

Key: MT = Maryland Tobacco; BT = Burley Tobacco

Note: Years reflect the year in which a crop was grown and the value received in the auction the following year. For crop production in year 2005, the Maryland tobacco was sold at the last auction held in the State and the burley tobacco reflects the estimated amount sold under direct contract. Starting in 2006, numbers reflect estimates of burley tobacco and Maryland tobacco sold only under direct contract.

Source: Maryland Department of Agriculture; University of Maryland Cooperative Extension

Recommendations

The Department of Legislative Services recommends that the Legislative Policy Committee waive the Maryland Tobacco Authority from full evaluation and that legislation be submitted in the 2009 legislative session to (1) remove the Maryland Tobacco Authority from statute; and (2) revert the \$1,625 fund balance to the general fund.

The authority is no longer needed since auctions of Maryland tobacco have ceased. Legislation should be submitted in the 2009 legislative session to remove the authority from statute. The legislation should revert the authority's \$1,625 fund balance to the general fund because (1) MDA's planned use of the funding for expenses related to the National Tobacco Grower Settlement Trust lawsuit is not within the statutory purposes of the authority; and (2) the fund balance may not be transferred for other purposes.

Tobacco *production* data will continue to be collected by the Maryland branch of the National Agricultural Statistics Service; there has not been an official estimate of tobacco *sales* since the demise of the auction system.

Appendix 1. Two Major Policies Impacting the Tobacco Industry in Maryland

1. Lawsuits and Law Changes Created Compensation and Tobacco Buyout Programs

Description

Lawsuits filed by individual states in the mid-1990s claimed violation of consumer protections by the tobacco companies. The lawsuits were settled in November 1998 by the 5 major tobacco companies with 46 states, 5 territories, and the District of Columbia. Under the Master Settlement Agreement (MSA) the tobacco companies will pay the parties \$206 billion over 25 years. In addition, language in the MSA required discussion of impacts to farmers due to increased cigarette costs and subsequent reduced demand due to the MSA.

As an outgrowth of the MSA requirement to discuss impacts to farmers, the tobacco companies agreed upon the National Tobacco Grower Settlement Trust (trust). The trust negotiation was for \$5.1 billion to be paid to qualifying tobacco growers and quota holders over 12 years with allowance for adjustments to this amount. The payment to tobacco growers in Maryland was approximately \$32.0 million for 12 years. However, the trust states that the tobacco companies' payment may be discontinued if the federal government required further payments.

In 2004 the Fair and Equitable Tobacco Reform Act (FETRA) passed as a component of the American Jobs Creation Act of 2004. FETRA created a federal tobacco buyout program, which is funded by an assessment placed on tobacco companies. The tobacco companies claim that no more payments into the trust are required because of the new payments required by FETRA.

Two other lawsuits have been filed relative to the tobacco companies' refusal to pay into the trust. The first lawsuit concerned whether the tobacco companies had to pay into the trust through 2004. Because the tobacco companies lost the lawsuit, the payments were continued through 2004 but have been suspended since then. The second lawsuit concerns whether the trust was negotiated with each state individually or all states as a whole. Maryland has not been involved in the federal price support system since 1965 and argues that the trust was negotiated with each state individually. Therefore, Maryland (along with North Carolina and Pennsylvania) filed a lawsuit stating FETRA did not apply and that trust payments should be continued. The second lawsuit is pending before the North Carolina Supreme Court.

Impact

Maryland set up the Cigarette Restitution Fund from the monies received from the MSA and uses it to fund the Southern Maryland Regional Strategy Action Plan for Agriculture (plan). A component of the plan is the State Tobacco Transition Program which was created to compensate tobacco farmers willing to commit to stop growing tobacco. The impact of the Tobacco Transition Program has been the reduced acres in tobacco production.

The Maryland Department of Agriculture notes that the Maryland Tobacco Transition Program was created with the understanding that farmers would be able to receive both MSA payments and trust payments. Therefore, if the trust payments are not reinstated, the intent of the Maryland Tobacco Transition Program would be undermined.

2. Shift to Direct Contracting

Description

In 2000 Philip Morris initiated direct contracting for burley and flue-cured tobacco.

Impact

Philip Morris' shift to direct contracting shut down a number of auctions in tobacco growing areas; however, the federal price support system kept the tobacco price high. Maryland tobacco was initially unaffected by this shift. However, with the phase out of Maryland tobacco auctions – primarily due to the success of the Maryland Tobacco Transition Program, direct contracting has allowed growers of burley tobacco and the remaining growers of Maryland tobacco to sell their crop.

Appendix 2. Tobacco Buyout in Maryland

As a result of the Master Settlement Agreement (MSA), the State of Maryland established the Cigarette Restitution Fund (CRF) in Chapter 173 of 1999 to be used for a variety of programs and initiatives, including programs to reduce tobacco growing in Maryland. Chapter 173 included the following language concerning the use of CRF moneys for the tobacco buyout: “implementation of the Southern Maryland Regional Strategy Action Plan for Agriculture adopted by the Tri-County Council for Southern Maryland (TCC) with an emphasis on alternative crop uses for agricultural land now used for growing tobacco.”

CRF moneys are appropriated to the Maryland Department of Agriculture, which issues grants to TCC for the tobacco buyout, infrastructure/agricultural development, and agricultural land preservation.

- The tobacco buyout component is a voluntary program that provides funds to support all eligible Maryland tobacco growers who choose to give up tobacco production forever while remaining in agricultural production. It also restricts the land from tobacco production for 10 years should the land transfer to new ownership.
- The infrastructure/agricultural development program seeks to foster profitable natural resource-based economic development for Southern Maryland by assisting farmers and related businesses to diversify, develop, and/or expand market-driven agricultural enterprises in the region through economic development and education.
- The agricultural land preservation component seeks to provide an incentive to tobacco farmers to place land in agricultural preservation, enhance participation in existing preservation programs, and assist in the acquisition of land for farmers’ markets.

Growers who participate in the buyout program are paid \$1.00 per pound of tobacco for 10 years. The sign-up period for the buyout program lasted from 2000 until 2004, a five-year time period, and so the 2005 auction year reflects the final participation in the buyout program. The tobacco buyout program originally was anticipated to have a program participation of around 68 percent of eligible growers, but as of the 2005 auction year – the final participation number – the program participation actually has been 83 percent as shown below.

**Actual Participation in Tobacco Buyout Program
(by Auction Year)**

	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
Growers Out of Tobacco					
Cumulative Number	560	656	714	781	854
Cumulative Percent	55	64	70	77	83
Pounds of Eligible Tobacco Out of Production (millions)					
Cumulative Number	5.44	6.41	6.79	7.33	7.65
Cumulative Percent	66	78	83	90	94

Source: Southern Maryland Agricultural Development Commission of the Tri-County Council for Southern Maryland

The 2004 sunset review notes two overstatements of participation. First, Amish and Mennonite farmers were not included in the estimates for eligible farmer participation in the buyout and, second, eligible farmers included anyone vested in a farm. However, since data are not available on the number of farms that stopped growing tobacco, the numbers do provide a proxy for the amount of participation in the program.

Chapter 103 of 2001 authorized the issuance of up to \$5 million in general obligation bonds per year for six years for use in implementing the tobacco buyout plan if the funding provided by CRF was not sufficient; the amount of money budgeted in total for the tobacco buyout plan is \$57,944,000. However, to meet the early requirements, bonds were planned to be issued in the amount of \$26,585,000. In fiscal 2008 a plan was devised to repay the bonds within 10 years. When the repayment plan was devised, the Southern Maryland Agricultural Development Commission of TTC requested that the plan be revisited in fiscal 2010 in order to determine the status of CRF payments.

The 2008 *Capital Improvement Program* (the State's five-year capital improvement plan) reflects the beginning of the planned bond repayment of \$3,323,000 in fiscal 2011. The tobacco buyout payments began in fiscal 2001 and are expected to end in fiscal 2014, which reflects the five-year rolling start of the sign-up and the 10-year overall time period in which any one tobacco farmer is eligible to receive payments. The bond repayment is scheduled to begin in fiscal 2011 and end in fiscal 2018. After the bond repayments are completed and assuming that the CRF revenue estimate does not change significantly in the out-years, TCC's agricultural land preservation program, infrastructure grants program, and administrative expense needs appear to be funded at no less than \$3.0 million annually.

The Southern Maryland Agricultural Development Commission expressed concern about what will happen in fiscal 2011 once the tobacco buyout payments end for the first group of recipients. The average age of tobacco farmers at the beginning of the program was 62, but is now 68. The concern is that these farmers most likely will not transition to other forms of agricultural production and may sell their land for nonagricultural uses.

Appendix 3. Written Comments on Behalf of the Maryland Tobacco Authority



Maryland Department of Agriculture

Agriculture | Maryland's Leading Industry

Office of Marketing, Animal Industries & Consumer Services

Martin O'Malley, Governor
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December 3, 2008

Ms. Laura McCarty
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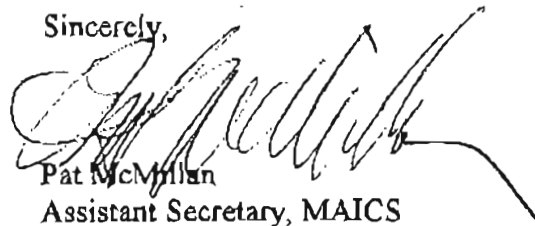
Dear Ms. McCarty:

I am writing to advise you that the Maryland Department of Agriculture concurs with the analyst's recommendations in the preliminary evaluation of the Maryland Tobacco Authority.

The Department will amend proposed Departmental legislation to abolish the Tobacco Authority so that the fund balance reverts to the General Fund in FY'09.

We appreciate Mr. Gray's thoughtful analysis of this matter and thank you for giving us the opportunity to comment.

Sincerely,



Pat McMillan
Assistant Secretary, MAICS

cc:

Roger Richardson, Secretary
Earl Hance, Deputy Secretary
Doug Wilson, Director Admin. Services
Andrew Gray, Analyst