KROGER CO
Form 10-K
April 07, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Fiscal year ended January 28, 2006.

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _________ to _________

Commission file number 1-303

THE KROGER CO.
(Exact name of registrant as specified in its charter)

Ohio	**31-0345740**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
1014 Vine Street, Cincinnati, OH 45202	**45202**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code (513) 762-4000

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock $1 par value 723,470,510 shares outstanding on March 31, 2006	New York Stock Exchange

Securities registered pursuant to section 12(g) of the Act:

NONE
(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes x No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act

Yes o No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

Indicate by check mark if disclosure of delinquent filer pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicated by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined by Rule 12b-2 of the Exchange Act).

Large accelerated filer x Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act).

Yes o No x

The aggregate market value of the Common Stock of The Kroger Co. held by non-affiliates as of March 31, 2006: $14,729,859,584

Documents Incorporated by Reference:

Proxy statement to be filed pursuant to Regulation 14A of the Exchange Act on or before May 30, 2006, incorporated by reference into Part III of Form 10-K.

PART I

ITEM 1. BUSINESS.

The Kroger Co. was founded in 1883 and incorporated in 1902. As of January 28, 2006, the Company was one of the largest retailers in the United States based on annual sales. The Company also manufactures and processes some of the food for sale in its supermarkets. The Company s principal executive offices are located at 1014 Vine Street, Cincinnati, Ohio 45202, and its telephone number is (513) 762-4000. The Company maintains a web site (www.kroger.com) that includes additional information about the Company. The Company makes available through its web site, free of charge, its annual reports on Form 10-K, its quarterly reports on Form 10-Q and its current reports on Form 8-K, including amendments thereto. These forms are available as soon as reasonably practicable after the Company has filed or furnished them electronically with the SEC.

The Company s revenues are earned and cash is generated as consumer products are sold to customers in its stores. The Company earns income predominantly by selling products at price levels that produce revenues in excess of its costs to make these products available to its customers. Such costs include procurement and distribution costs, facility occupancy and operational costs, and overhead expenses.

Employees

The Company employs approximately 290,000 full and part-time employees. A majority of the Company s employees are covered by collective bargaining agreements negotiated with local unions affiliated with one of several different international unions. There are approximately 325 such agreements, usually with terms of three to five years.

During fiscal 2005, major collective bargaining agreements were ratified in Atlanta, Columbus, Dallas, Portland (non-food), Roanoke, as well as Teamsters contracts covering southern California and several facilities in the Midwest.

During fiscal 2006, the Company has various labor contracts expiring throughout the country; there are fewer employees covered by the contracts that expire in 2006 than was the case in 2005.

Stores

As of January 28, 2006, the Company operated, either directly or through its subsidiaries, 2,507 supermarkets, 579 of which had fuel centers. Approximately 35% of these supermarkets were operated in Company-owned facilities, including some Company-owned buildings on leased land. The Company s current strategy emphasizes self-development and ownership of store real estate. The Company s stores operate under several banners that have strong local ties and brand equity. Supermarkets are generally operated under one of the following formats: combination food and drug stores (combo stores); multi-department stores; price impact warehouses; or marketplace stores.

The combo stores are the primary food store format. They are typically able to earn a return above the Company s cost of capital by drawing customers from a 2 2½ mile radius. The Company believes this format is successful because the stores are large enough to offer the specialty departments that customers desire for one-stop shopping, including whole health sections, pharmacies, general merchandise, pet centers and high-quality perishables such as fresh seafood and organic produce. Many combo stores include a fuel center.

Multi-department stores are significantly larger in size than combo stores. In addition to the departments offered at a typical combo store, multi-department stores sell a wide selection of general merchandise items such as apparel, home fashion and furnishings, electronics, automotive, toys and fine jewelry. Many multi-department stores include a fuel center.

Price impact warehouse stores offer a no-frills, low cost warehouse format and feature everyday low prices plus promotions for a wide selection of grocery and health and beauty care items. Quality meat, dairy, baked goods and fresh produce items provide a competitive advantage. The average size of a price impact warehouse store is similar to that of a combo store.

In addition to supermarkets, the Company operates, either directly or through subsidiaries, 791 convenience stores and 428 fine jewelry stores. Substantially all of our fine jewelry stores are operated in leased locations. Subsidiaries operated 701 of the convenience stores, while 90 were operated through franchise agreements. Approximately 45% of the convenience stores operated by subsidiaries were operated in company-owned facilities. The convenience stores offer a limited assortment of staple food items and general merchandise and, in most cases, sell gasoline.

Segments

The Company operates retail food and drug stores, multi-department stores, jewelry stores, and convenience stores throughout the United States. The Company s retail operations, which represent substantially all of the Company s consolidated sales, earnings and total assets, are its only reportable segment. All of the Company s operations are domestic. Revenues, profit and losses, and total assets are shown in the Company s Consolidated Financial Statements set forth in Item 8 below.

Merchandising and Manufacturing

Corporate brand products play an important role in the Company s merchandising strategy. Supermarket divisions typically stock approximately 10,000 private label items. The Company s corporate brand products are produced and sold in three quality tiers. Private Selection is the premium quality brand designed to meet or beat the gourmet or upscale brands. The banner brand (Kroger, Ralphs, King Soopers, etc.), which represents the majority of the Company s private label items, is designed to be equal to or better than the national brand and carries the Try It, Like It, or Get the National Brand Free guarantee. FMV (For Maximum Value) is the value brand, designed to deliver good quality at a very affordable price.

Approximately 55% of the corporate brand units sold are produced in the Company s manufacturing plants; the remaining corporate brand items are produced to the Company s strict specifications by outside manufacturers. The Company performs a make or buy analysis on corporate brand products and decisions are based upon a comparison of market-based transfer prices versus open market purchases. As of January 28, 2006, the Company operated 42 manufacturing plants. These plants consisted of 18 dairies, 11 deli or bakery plants, five grocery product plants, three beverage plants, three meat plants and two cheese plants.

Executive Officers of the Registrant

The disclosure regarding executive officers is set forth in Item 10 of Part III of this Form 10-K under the heading Executive Officers of the Company, and is incorporated herein by reference.

ITEM 1A. RISK FACTORS.

There are risks and uncertainties that can affect our business. The significant risk factors are discussed below. Please also see the Outlook section in Item 7 of this Form 10-K for additional uncertainties and other risk factors that could adversely affect our business.

Competitive Environment

The operating environment for the food retailing industry continues to be characterized by intense price competition, aggressive supercenter expansion, increasing fragmentation of retail formats, entry of non-traditional competitors and market consolidation. We have developed a strategic plan that we believe is a balanced approach that will enable Kroger to meet the wide-ranging needs and expectations of our customers. However, the nature and extent to which our competitors implement various pricing and promotional activities in response to increasing competition - including our execution of our strategic plan - and our response to these competitive actions, can adversely affect our profitability.

Food Safety

Customers count on Kroger to provide them with wholesome food products. Concerns regarding the safety of food products sold by Kroger could cause shoppers to avoid purchasing certain products from us, or to seek alternative sources of supply for all of their food needs, even if the basis for the concern is outside of our control. Any lost confidence on the part of our customers would be difficult and costly to reestablish. As such, any issue regarding the safety of any food items sold by Kroger, regardless of the cause, could have a substantial and adverse effect on our operations.

Labor Relations

A significant majority of our employees are covered by collective bargaining agreements with unions, and our relationship with those unions, including any work stoppages, could have an adverse impact on our financial results.

We are a party to approximately 325 collective bargaining agreements, of which 85 of the contracts, covering fewer employees than those that expired in 2005, are scheduled to expire in 2006. These expiring agreements cover approximately 8% of our union-affiliated employees. In future negotiations with labor unions, we expect that rising health care, pension and employee benefit costs, among other issues, will continue to be important topics for negotiation. Upon the expiration of our collective bargaining agreements, work stoppages by the affected workers could occur if we are unable to negotiate acceptable contracts with labor unions. This could significantly disrupt our operations. Further, if we are unable to control health care and pension costs provided for in the collective bargaining agreements, we may experience increased operating costs and an adverse impact on future results of operations.

Strategy Execution

Our strategy focuses on improving our customers shopping experience through enhanced service, product selection and value. Successful execution of this strategy requires a balance between sales growth and earnings growth. Maintaining this strategy requires the ability to identify and execute plans to generate cost savings and productivity improvements that can be invested in the merchandising and pricing initiatives necessary to support our customer-focused programs, as well as recognizing and implementing organizational changes as required. If we are unable to identify or execute plans that generate the requisite amount of cost savings necessary to execute our strategy and to meet our customers expectations, our sales and earnings growth expectations could be adversely affected.

Indebtedness

As of year-end 2005, Kroger s outstanding indebtedness, including capital leases and financing obligations, totaled approximately $7.2 billion. This indebtedness could reduce our ability to obtain additional financing for working capital, acquisitions or other purposes and could make us more vulnerable to economic downturns and competitive pressures. Our need for cash in the future will depend on many factors that are difficult to predict. These factors include results of operations, the timing and cost of acquisitions and efforts to expand existing operations. We believe that we will have sufficient funds from all sources to meet our needs over the next several years.

Legal Proceedings

From time to time, we are a party to legal proceedings, including matters involving personnel and employment issues, personal injury, antitrust claims and other proceedings. Some of these proceedings, including product liability cases, could result in a substantial loss to Kroger in the event that other potentially responsible parties are unable (for financial reasons or otherwise) to satisfy a judgment entered against them. Others purport to be brought as class actions on behalf of similarly situated parties. We estimate our exposure to these legal proceedings and establish accruals for the estimated liabilities. Assessing and predicting the outcome of these matters involves substantial uncertainties. While we currently do not expect any outstanding legal proceeding to have a material effect on the financial condition of Kroger, unexpected outcomes in these legal proceedings, or changes in our evaluations or predictions about the proceedings, could have a material adverse effect on our financial results. Please also refer to the Legal Proceedings section in Item 3 below.

Multi-Employer Post-Retirement Obligations

As discussed in more detail below in Management s Discussion and Analysis of Financial Condition and Results of Operation-Critical Accounting Policies-*Post-Retirement Benefit Plans*, Kroger contributes to several multi-employer pension plans based on obligations arising under collective bargaining agreements with unions representing employees covered by those agreements. In addition to future contribution obligations that Kroger may have under those plans, there is a risk that the agencies that rate Kroger s outstanding debt instruments could view the underfunded nature of these plans unfavorably when determining their ratings on the Company s debt securities. Any downgrading of Kroger s debt ratings likely would increase Kroger s cost of borrowing.

Insurance

We use a combination of insurance and self-insurance to provide for potential liability for workers compensation, automobile and general liability, property insurance, director and officers liability insurance, and employee health care benefits. The liabilities that have been recorded for these claims represent our best estimate, using generally accepted actuarial reserving methods, of the ultimate obligations for reported claims plus those incurred but not reported for all claims incurred through January 28, 2006. Any actuarial projection of losses is subject to a high degree of variability. Changes in legal trends and interpretations, variability in inflation rates, changes in the nature and method of claims settlement, benefit level changes due to changes in applicable laws, and changes in discount rates could all affect ultimate settlements of claims.

ITEM 1B. UNRESOLVED STAFF COMMENTS.

None.

ITEM 2. PROPERTIES.

As of January 28, 2006, the Company operated more than 3,600 owned or leased supermarkets, convenience stores, fine jewelry stores, distribution warehouses and food processing facilities through divisions, subsidiaries or affiliates. These facilities are located throughout the United States. A majority of the properties used to conduct the Company s business are leased.

The Company generally owns store equipment, fixtures and leasehold improvements, as well as processing and manufacturing equipment. The total cost of the Company s owned assets and capitalized leases at January 28, 2006, was $19,786 million while the accumulated depreciation was $8,421 million.

Leased premises generally have base terms ranging from ten-to-twenty years with renewal options for additional periods. Some options provide the right to purchase the property after conclusion of the lease term. Store rentals are normally payable monthly at a stated amount or at a guaranteed minimum amount plus a percentage of sales over a stated dollar volume. Rentals for the distribution, processing and miscellaneous facilities generally are payable monthly at stated amounts. For additional information on lease obligations, see Note 10 to the Consolidated Financial Statements.

ITEM 3. LEGAL PROCEEDINGS.

In December, 2005, the United States Attorney s Office for the Central District of California notified the Company that a federal grand jury had returned an indictment against Ralphs Grocery Company (Ralphs), a wholly-owned subsidiary of The Kroger Co., with regard to Ralphs hiring practices during the labor dispute from October 2003 through February 2004 (United States of America v. Ralphs Grocery Company, United States District Court for the Central District of California, CR No. 05-1210 PA). The indictment alleges a criminal conspiracy and other criminal activity resulting in some locked-out employees being allowed or encouraged to work under false identities or false Social Security numbers, despite Company policy forbidding such conduct. Trial has been set for August 15, 2006. The Company has been informed that the grand jury continues to investigate whether additional parties, including Kroger, should be held liable for the alleged misconduct. In addition, these alleged hiring practices are the subject of claims that Ralphs conduct of the lockout was unlawful, and that Ralphs is liable under the National Labor Relations Act (NLRA). The Los Angeles Regional Office of the National Labor Relations Board (NLRB) has notified the charging parties that all charges alleging that Ralphs lockout violated the NLRA have been dismissed. That decision is being appealed by the charging parties to the General Counsel of the NLRB. The amounts potentially claimed in both the criminal and the NLRB matter are substantial, but based on the information presently available to the Company, management does not expect the ultimate resolution of this matter to have a material effect on the financial condition of the Company.

On September 8, 2005, the Los Angeles City Attorney s office filed a misdemeanor complaint against a subsidiary of the Company, Ralphs Grocery Company (People v. Ralphs Grocery Company, Superior Court of California, County of Los Angeles, Case No. 5CR02616) regarding alleged violations of the California Water Code. Ralphs operates a system at one store location to treat groundwater within an underground basement because of the presence of naturally occurring petroleum associated with the nearby La Brea tar pits, which system is subject to a discharge permit issued by the California Regional Water Quality Control Board. On December 1, 2005, Ralphs executed a civil consent judgment, the misdemeanor complaint was dismissed and Ralphs paid a civil penalty of $37,000.

On February 2, 2004, the Attorney General for the State of California filed an action in Los Angeles federal court (California, ex rel Lockyer v. Safeway, Inc. dba Vons, a Safeway Company; Albertson s, Inc. and Ralphs Grocery Company, a division of The Kroger Co., United States District Court Central District of California, Case No. CV04-0687) alleging that the Mutual Strike Assistance Agreement (the Agreement) between the Company, Albertson s, Inc. and Safeway Inc. (collectively, the Retailers), which was designed to prevent the union from placing disproportionate pressure on one or more of the Retailers by picketing such Retailer(s) but not the other Retailer(s) during the labor dispute in southern California, violated Section 1 of the Sherman Act. The lawsuit seeks declarative and injunctive relief. On May 25, 2005, the Court denied a motion for a summary judgment filed by the defendants. Ralphs and the other defendants filed a notice of an interlocutory appeal to the United States Court of Appeals for the Ninth Circuit. On November 29, 2005, the appellate court dismissed the appeal. The Company continues to believe it has strong defenses against this lawsuit and is vigorously defending it. Although this lawsuit is subject to uncertainties inherent to the litigation process, based on the information presently available to the Company, management does not expect that the ultimate resolution of this action will have a material effect, favorable or adverse, on the Company s financial condition, results of operations or cash flows.

Ralphs Grocery Company is the defendant in a group of civil actions initially filed in 2003 and for which a coordination order was issued on January 20, 2004 in The Great Escape Promotion Cases pending in the Superior Court of California, County of Los Angeles, Case No. JCCP No. 4343. The plaintiffs allege that Ralphs violated various laws protecting consumers in connection with a promotion pursuant to which Ralphs offered travel awards to customers. On February 22, 2006, the Court in The Great Escape Promotion Cases issued an Order granting preliminary approval of the class action settlement. Notice of the class action settlement should be sent to class members within the next 90 days, and the date set for final approval of the class action settlement is set for August 25, 2006. The Company has no reason to believe that final approval will not be obtained, and management does not believe the ultimate outcome will have a material effect on the Company s financial condition.

On August 12, 2000, Ralphs Grocery Company, along with several other potentially responsible parties, entered into a consent decree with the U. S. Environmental Protection Agency surrounding the purported release of volatile organic compounds in connection with industrial operations at a property located in Los Angeles, California. The consent decree followed the EPA s earlier Administrative Order No. 97-18 in which the EPA sought remedial action pursuant to its authority under the Comprehensive Environmental Remediation, Compensation and Liability Act. Under the consent decree, Ralphs contributes a share of the costs associated with groundwater extraction and treatment, which share currently totals approximately $30,000-$40,000 per year. The treatment process is expected to continue until at least 2012.

Various claims and lawsuits arising in the normal course of business, including suits charging violations of certain antitrust and civil rights laws, are pending against the Company. Some of these suits purport or have been determined to be class actions and/or seek substantial damages. Any damages that may be awarded in antitrust cases will be automatically trebled. Although it is not possible at this time to evaluate the merits of all of these claims and lawsuits, nor their likelihood of success, the Company is of the belief that any resulting liability will not have a material adverse effect on the Company s financial position.

The Company continually evaluates its exposure to loss contingencies arising from pending or threatened litigation and believes it has made adequate provisions therefor. Nonetheless, assessing and predicting the outcomes of these matters involve substantial uncertainties. It remains possible that despite management s current belief, material differences in actual outcomes or changes in management s evaluation or predictions could arise that could have a material adverse impact on the Company s financial condition or results of operation.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

None.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

(a)

COMMON STOCK PRICE RANGE

	2005		2004	
Quarter	**High**	**Low**	**High**	**Low**
1st	**$ 18.22**	**$ 15.15**	$ 19.67	$ 15.95
2nd	**$ 20.00**	**$ 16.46**	$ 18.36	$ 14.70
3rd	**$ 20.88**	**$ 19.09**	$ 17.31	$ 14.65
4th	**$ 20.58**	**$ 18.42**	$ 17.75	$ 15.53

Main trading market: New York Stock Exchange (Symbol KR)

Number of shareholders of record at year-end 2005: 50,522

Number of shareholders of record at March 31, 2006: 54,742

Determined by number of shareholders of record

The Company has not paid dividends on its Common Stock for the past three fiscal years. On March 7, 2006, the Company announced that its Board of Directors had adopted a dividend policy and declared the payment of a quarterly dividend of $0.065 per share to shareholders of record at the close of business on May 15, 2006, to be paid on June 1, 2006.

The information regarding equity compensation plans is set forth in Item 12 of this Form 10-K and is incorporated by reference into this Item 5.

(c)

ISSUER PURCHASES OF EQUITY SECURITIES

Period [1]	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs [2]	Maximum Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs [3] (in millions)
First four weeks				
November 6, 2005 to December 3, 2005	191,497	$ 19.42	190,000	$ 154
Second four weeks				
December 4, 2005 to December 31, 2005	670,000	$ 19.07	370,000	$ 147
Third four weeks				
January 1, 2006 to January 28, 2006	1,978,628	$ 18.88	1,750,000	$ 114
Total	2,840,125	$ 18.97	2,310,000	$ 114

(1) The reported periods conform to the Company s fiscal calendar composed of thirteen 28-day periods. The fourth quarter of 2005 contained three 28-day periods.

(2) Shares were repurchased under (i) a $500 million stock repurchase program, authorized by the Board of Directors on September 16, 2004, and (ii) a program announced on December 6, 1999, to repurchase common stock to reduce dilution resulting from our employee stock option plans, which program is limited to proceeds received from exercises of stock options and the tax benefits associated therewith. The programs have no expiration date but may be terminated by the Board of Directors at any time. No shares were purchased other than through publicly announced programs during the periods shown.

(3) Amounts shown in this column reflect amounts remaining under the $500 million stock repurchase program referenced in Note 2 above. Amounts to be invested under the program utilizing option exercise proceeds are dependent upon option exercise activity.

ITEM 6. SELECTED FINANCIAL DATA.

	Fiscal Years Ended				
	January 28, 2006 (52 weeks)	January 29, 2005 (52 weeks)	January 31, 2004 (52 weeks)	February 1, 2003 (52 weeks)	February 2, 2002 (52 weeks)
	(In millions, except per share amounts)				
Sales	**$ 60,553**	$ 56,434	$ 53,791	$ 51,760	$ 50,098
Earnings (loss) before cumulative effect of accounting change	**958**	(104)	285	1,218	1,040
Cumulative effect of accounting change[1]				(16)	
Net earnings (loss)	**958**	(104)	285	1,202	1,040
Diluted earnings (loss) per share:					
Earnings (loss) before cumulative effect of accounting change	**1.31**	(0.14)	0.38	1.54	1.26
Cumulative effect of accounting change[1]				(.02)	
Net earnings (loss)	**1.31**	(0.14)	0.38	1.52	1.26
Total assets	**20,482**	20,491	20,767	20,349	19,100
Long-term liabilities, including obligations under capital leases and financing obligations	**9,377**	10,537	10,515	10,569	10,005
Shareowners equity	**4,390**	3,619	4,068	3,937	3,592
Cash dividends per common share[2]					

(1) Amounts are net of tax. Refer to Note 4 of the Consolidated Financial Statements.

(2) During the fiscal year ended February 2, 2002, the Company was prohibited from paying cash dividends under the terms of its previous Credit Agreement. On May 22, 2002, the Company entered into a new Credit Agreement, at which time the restriction on payment of cash dividends was eliminated. However, no cash dividends were declared or paid in any of the periods presented.

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION.

Our Business

The Kroger Co. was founded in 1883 and incorporated in 1902. It is one of the nation s largest retailers, operating 2,507 stores under two dozen banners including Kroger, Ralphs, Fred Meyer, Food 4 Less, King Soopers, Smith s, Fry s, Fry s Marketplace, Dillons, QFC and City Market. Of these stores, 579 had fuel centers. The Company also operates 791 convenience stores and 428 fine jewelry stores.

Kroger operates 42 manufacturing plants, primarily bakeries and dairies, which supply approximately 55% of the corporate brand units sold in the Company s retail outlets.

Our revenues are earned and cash is generated as consumer products are sold to customers in our stores. We earn income predominately by selling products at price levels that produce revenues in excess of our costs to make these products available to our customers. Such costs include procurement and distribution costs, facility occupancy and operational costs, and overhead expenses. The Company s operations are reported as a single reportable segment: the retail sale of merchandise to individual customers.

Our 2005 Performance

The continued focus of Kroger s associates on delivering improved service, product selection and value to our customers generated a year of significantly improved identical supermarket sales growth in 2005. The 3.5% annual identical food store sales growth, without fuel, achieved in 2005 outpaced the 0.8% identical sales growth achieved on the same basis in 2004, and is a significant improvement over declining identical food store sales experienced in 2003. The fourth quarter growth was broad-based and included all retail divisions and store departments. Through the fourth quarter of 2005, we have achieved ten consecutive quarters of positive identical supermarket sales growth, excluding supermarket fuel sales.

Our internal analysis shows that we hold the #1 or #2 position in 35 of our 44 major markets. We define a major market as one in which we operate nine or more stores. According to our internal market share estimates, which include all retail outlets including supercenters and other non-traditional retail formats, Kroger s market share increased in 29 of these 44 markets in 2005, declined in 12 and remained unchanged in three. On a volume-weighted basis, Kroger s overall market share in these 44 markets increased 35 basis points.

Kroger competes in 32 major markets where supercenters have achieved at least a #3 market share position. Kroger s overall market share in these 32 markets rose more than 50 basis points during 2005, on a volume-weighted basis. Our market share increased in 24 of those markets, declined in seven, and remained unchanged in one.

These market share data illustrate that Kroger continues to grow, despite an operating environment in the food retailing industry that continues to be characterized by intense price competition, aggressive supercenter expansion, increasing fragmentation of retail formats, and market consolidation. Kroger s retail price investments, combined with our service and selling initiatives led to these market share gains in 2005. We believe this growth can continue. In our 44 major markets, almost 50% of the share in those markets is held by competitors without our economies of scale.

Kroger has been able to balance its sales growth with earnings growth. Our net earnings increased to $1.31 per diluted share in 2005, from $1.02 per share, excluding the effect of goodwill impairment charges, in 2004. We were not only able to leverage sales improvements to achieve earnings growth, but also offset investments in targeted retail price reductions and higher energy, credit card and pension costs with continued recovery from the 2003-2004 labor dispute in southern California, as well as improvements in shrink, advertising, warehousing, and health care costs.

Future Expectations

While we were very pleased with our 2005 results, we continue to develop our business model to meet the changing needs and expectations of our customers. Our plan requires balance between sales growth, earnings growth and profitable capital investment.

We expect to achieve identical supermarket sales growth through merchandising and operating initiatives that improve the shopping experience and build customer loyalty. We expect 2006 food store identical sales growth, excluding fuel sales, to exceed 3.5%.

To the extent that these sales initiatives involve price reductions or additional costs, we expect they will be funded by operating cost reductions and productivity improvements. We expect sales improvements and cost reductions, combined with fewer shares outstanding due to continued share repurchase activity, to drive earnings per share growth in 2006. Kroger expects to deliver earnings per share growth in 2006 of approximately 6% to 8%. This includes the effect of a 53rd week in fiscal 2006, substantially offset by the expected effect of expensing of stock options, which we anticipate will reduce net earnings approximately $0.05-$0.06 per diluted share. See Recently Issued Accounting Standards for additional discussion of the expensing of stock options beginning in 2006.

In addition, on March 7, 2006, we announced that Kroger s Board of Directors declared the payment of a quarterly dividend of $0.065 per share. The payment will be made June 1, 2006 to holders of record at the close of business on May 15, 2006.

Further discussion on our industry, the current economic environment, and our related strategic plans is included in Outlook.

Results of Operations

The following discussion summarizes our operating results for 2005 compared to 2004 and for 2004 compared to 2003. Comparability is affected by certain income and expense items that fluctuated significantly between and among the periods, including goodwill and asset impairment charges and labor disputes in West Virginia and southern California.

Net Earnings (Loss)

Net earnings totaled $958 million for 2005, compared to a net loss totaling $104 million in 2004 and net earnings totaling $285 million in 2003. The increase in our net earnings for 2005, compared to 2004 and 2003, resulted from improvements in the southern California market and the leveraging of fixed costs with strong identical supermarket sales growth. In addition, 2004 and 2003 were affected by goodwill and asset impairment charges totaling $904 million and $591 million, respectively, as well as labor disputes in West Virginia and southern California.

Earnings per diluted share totaled $1.31 in 2005, compared to a net loss of $0.14 per share in 2004 and earnings of $0.38 per diluted share in 2003. Net earnings were reduced by $1.16 per share in 2004 and $0.78 per diluted share in 2003 due to the effects of goodwill and asset impairment charges. Our earnings per share growth in 2005 resulted from increased net earnings and the repurchase of Kroger stock. During fiscal 2005, we repurchased 15 million shares of Kroger stock for a total investment of $252 million. During fiscal 2004, we repurchased 20 million shares of our stock for a total investment of $319 million. During fiscal 2003, we repurchased 19 million shares of Kroger stock for a total investment of $301 million.

Sales

Total Sales
(in millions)

		2005	Percentage Increase		2004	Percentage Increase		2003
Total food store sales without fuel	$	53,472	4.6%	$	51,106	2.9%	$	49,650
Total food store fuel sales		3,526	53.0%		2,305	59.0%		1,450
Total food store sales	$	56,998	6.7%	$	53,411	4.5%	$	51,100
Other sales		3,555	17.6%		3,023	12.3%		2,691
Total Sales	$	60,553	7.3%	$	56,434	4.9%	$	53,791

Our total sales rose as a result of increased identical supermarket sales and square footage growth, as well as inflation in fuel and other commodities.

We define a supermarket as identical when it has been in operation without expansion or relocation for five full quarters. Differences between total supermarket sales and identical supermarket sales primarily relate to changes in supermarket square footage. We calculate annualized identical supermarket sales based on a summation of four quarters of identical supermarket sales. Our identical supermarket sales results are summarized in the table below.

Identical Supermarket Sales
(in millions)

		2005		2004
Including fuel centers	$	54,144	$	51,413
Excluding fuel centers	$	50,866	$	49,154
Including fuel centers		5.3%		2.1%
Excluding fuel centers		3.5%		0.8%

We define a supermarket as comparable store when it has been in operation for five full quarters, including expansions and relocations. We calculate annualized comparable supermarket sales based on a summation of four quarters of comparable sales. Our annualized comparable supermarket sales results are summarized in the table below.

Comparable Supermarket Sales
(in millions)

		2005		2004
Including supermarket fuel centers	$	55,607	$	52,514
Excluding supermarket fuel centers	$	52,200	$	50,226
Including supermarket fuel centers		5.9%		2.6%
Excluding supermarket fuel centers		3.9%		1.3%

FIFO Gross Margin

We calculate First-In, First-Out (FIFO) Gross Margin as follows: Sales minus merchandise costs plus Last-In, First-Out (LIFO) charge (credit). Merchandise costs include advertising, warehousing and transportation, but exclude depreciation expense and rent expense. FIFO gross margin is an important measure used by our management to evaluate merchandising and operational effectiveness. Our FIFO gross margin rates were 24.80%, 25.38% and 26.38% in 2005, 2004 and 2003, respectively. Excluding the effect of retail fuel operations, our FIFO gross margin rates were 26.69%, 26.73% and 27.31% in 2005, 2004 and 2003, respectively. The growth in our retail fuel sales lowers our FIFO gross margin rate due to the very low FIFO gross margin on retail fuel sales as compared to non-fuel sales. The declining rates on our non-fuel sales reflect our continued investment in lower retail prices for our customers. In 2005, improvements in shrink, advertising and warehousing costs helped offset higher energy costs and our investments in targeted retail price reductions for our customers. We estimate higher energy costs decreased our FIFO gross margin rate on non-fuel sales by 5 basis points in 2005.

Operating, General and Administrative Expenses

Operating, general and administrative (OG&A) expenses consist primarily of employee-related costs such as wages, health care benefit costs and retirement plan costs. Among other items, rent expense, depreciation and amortization expense, and interest expense are not included in OG&A. OG&A expenses, as a percent of sales, were 18.21%, 18.76% and 19.25% in 2005, 2004 and 2003, respectively. Excluding the effect of retail fuel operations, our OG&A rates were 19.68%, 19.81% and 19.98% in 2005, 2004 and 2003, respectively. The growth in our retail fuel sales lowers our OG&A rate due to the very low OG&A rate on retail fuel sales as compared to non-fuel sales. The declining rate on non-fuel sales was primarily the result of our continued recovery in southern California, strong identical supermarket sales growth, labor productivity improvements, lower health care costs and $12.9 million of settlement income related to a previous class-action credit card lawsuit. These improvements were partially offset by increased pension costs, credit card fees and incentive plan expenses, increases in reserves for certain legal matters, the writedown to fair market value of assets held for sale, and the effects of hurricanes Katrina and Rita. We estimate higher energy costs increased our 2005 OG&A rate on non-fuel sales by 7 basis points.

Rent Expense

Rent expense was $661 million in 2005, as compared to $680 million and $657 million in 2004 and 2003, respectively. The decrease in rent expense reflects our continued emphasis on ownership of real estate. The decline from 2004 was also affected by a decrease in charges for the net present value of lease liabilities recorded for store closings.

Depreciation Expense

Depreciation expense was $1,265 million, $1,256 million and $1,209 million for 2005, 2004 and 2003, respectively. The slight increase in depreciation expense in 2005 was the result of current capital expenditures of $1.3 billion. Capital expenditures in 2004 and 2003 were $1.6 billion and $2.0 billion, respectively.

Interest Expense

Net interest expense totaled $510 million, $557 million and $604 million for 2005, 2004 and 2003, respectively. The decrease in interest expense is the result of lower average borrowings. During 2005, we reduced total debt $739 million from $8.0 billion as of January 29, 2005 to $7.2 billion as of January 28, 2006. Interest expense in 2004 and 2003 included $25 million and $18 million, respectively, related to the early retirement of debt.

Income Taxes

Our effective income tax rate was 37.2%, 136.4% and 61.4% for 2005, 2004 and 2003, respectively. The effective tax rates for 2004 and 2003 differ from the effective tax rate for 2005 due to the impairment of non-deductible goodwill in 2004 and 2003. The effective income tax rates also differ from the expected federal statutory rate in all years presented due to the effect of state taxes.

Common Stock Repurchase Program

We maintain a trading plan under Securities Exchange Act Rule 10b5-1 to allow for our repurchase of Kroger common stock, from time to time, even though we may be aware of material non-public information, as long as purchases are made in accordance with the plan. We made open market purchases totaling $239 million, $291 million and $277 million under this repurchase program during fiscal 2005, 2004 and 2003, respectively. In addition to this repurchase program, in December 1999 we began a program to repurchase common stock to reduce dilution resulting from our employee stock option plans. This program is solely funded by proceeds from stock option exercises, including the tax benefit from these exercises. We repurchased approximately $13 million, $28 million and $24 million under the stock option program during 2005, 2004 and 2003, respectively.

Capital Expenditures

Capital expenditures, excluding acquisitions, totaled $1.3 billion in 2005 compared to $1.6 billion in 2004 and $2.0 billion in 2003. The decline in 2005 and 2004 was the result of our emphasis on the tightening of capital and increasing our focus on remodels, merchandising and productivity projects. Capital expenditures in 2003 included $202 million related to the purchase of assets previously financed under a synthetic lease. The table below shows our supermarket storing activity and our total food store square footage:

Supermarket Storing Activity

	2005	2004	2003
Beginning of year	**2,532**	2,532	2,488
Opened	**28**	41	44
Opened (relocation)	**12**	20	14
Acquired	**1**	15	25
Acquired (relocation)		3	5
Closed (operational)	**(54)**	(56)	(25)
Closed (relocation)	**(12)**	(23)	(19)
End of year	**2,507**	2,532	2,532
Total food store square footage (in millions)	**142**	141	140

Critical Accounting Policies

We have chosen accounting policies that we believe are appropriate to report accurately and fairly our operating results and financial position, and we apply those accounting policies in a consistent manner. Our significant accounting policies are summarized in Note 1 to the Consolidated Financial Statements.

The preparation of financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses, and related disclosures of contingent assets and liabilities. We base our estimates on historical experience and other factors we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from those estimates.

We believe that the following accounting policies are the most critical in the preparation of our financial statements because they involve the most difficult, subjective or complex judgments about the effect of matters that are inherently uncertain.

Self-Insurance Costs

We primarily are self-insured for costs related to workers compensation and general liability claims. The liabilities represent our best estimate, using generally accepted actuarial reserving methods, of the ultimate obligations for reported claims plus those incurred but not reported for all claims incurred through January 28, 2006. Case-reserves are established for reported claims using case-basis evaluation of the underlying claim data and are updated as information becomes known.

The liabilities for workers compensation claims are accounted for on a present value basis utilizing a risk-adjusted discount rate. The difference between the discounted and undiscounted workers compensation liabilities was $17 million as of January 28, 2006. For both workers compensation and general liability claims, we have purchased stop-loss coverage to limit our exposure to any significant exposure on a per claim basis. We are insured for covered costs in excess of these per claim limits. General liability claims are not discounted.

We are also similarly self-insured for property-related losses. We have purchased stop-loss coverage to limit our exposure to losses in excess of $10 million on a per claim basis.

The assumptions underlying the ultimate costs of existing claim losses are subject to a high degree of unpredictability, which can affect the liability recorded for such claims. For example, variability in inflation rates of health care costs inherent in these claims can affect the amounts realized. Similarly, changes in legal trends and interpretations, as well as a change in the nature and method of how claims are settled can affect ultimate costs. Although our estimates of liabilities incurred do not anticipate significant changes in historical trends for these variables, any changes could have a considerable effect upon future claim costs and currently recorded liabilities.

Impairments of Long-Lived Assets

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we monitor the carrying value of long-lived assets for potential impairment each quarter based on whether certain trigger events have occurred. These events include current period losses combined with a history of losses or a projection of continuing losses or a significant decrease in the market value of an asset. When a trigger event occurs, an impairment calculation is performed, comparing projected undiscounted cash flows, utilizing current cash flow information and expected growth rates related to specific stores, to the carrying value for those stores. If impairment is identified for long-lived assets to be held and used, we compare discounted future cash flows to the asset s current carrying value. We record impairment when the carrying value exceeds the discounted cash flows. With respect to owned property and equipment held for disposal, the value of the property and equipment is adjusted to reflect recoverable values based on our previous efforts to dispose of similar assets and current economic conditions. Impairment is recognized for the excess of the carrying value over the estimated fair market value, reduced by estimated direct costs of disposal.

We perform impairment reviews at both the division and corporate levels. Generally, for reviews performed by local management, costs to reduce the carrying value of long-lived assets are reflected in the Consolidated Statements of Earnings as Operating, general and administrative expense. Costs to reduce the carrying value of long-lived assets that result from corporate-level strategic plans are separately identified in the Consolidated Statements of Earnings as Asset impairment charges.

The factors that most significantly affect the impairment calculation are our estimates of future cash flows. Our cash flow projections look several years into the future and include assumptions on variables such as inflation, the economy and market competition. Application of alternative assumptions and definitions, such as reviewing long-lived assets for impairment at a different organizational level, could produce significantly different results.

Goodwill

We review goodwill for impairment during the fourth quarter of each year, and also upon the occurrence of trigger events. The reviews are performed at the operating division level. Generally, fair value represents a multiple of earnings, or discounted projected future cash flows, and is compared to the carrying value of a division for purposes of identifying potential impairment. Projected future cash flows are based on management s knowledge of the current operating environment and expectations for the future. If potential for impairment is identified, the fair value of a division is measured against the fair value of its underlying assets and liabilities, excluding goodwill, to estimate an implied fair value of the division s goodwill. Goodwill impairment is recognized for any excess of the carrying value of the division s goodwill over the implied fair value. Results of the goodwill impairment reviews performed during 2005, 2004 and 2003 are summarized in Note 4 to the Consolidated Financial Statements.

The annual impairment review requires the extensive use of accounting judgment and financial estimates. Application of alternative assumptions and definitions, such as reviewing goodwill for impairment at a different organizational level, could produce significantly different results. Similar to our policy on impairment of long-lived assets, the cash flow projections embedded in our goodwill impairment reviews can be affected by several items such as inflation, the economy and market competition.

Intangible Assets

In addition to goodwill, we have recorded intangible assets totaling $35 million, $20 million and $30 million for leasehold equities, liquor licenses and pharmacy prescription file purchases, respectively, at January 28, 2006. Balances at January 29, 2005, were $40 million, $20 million and $29 million for lease equities, liquor licenses and pharmacy prescription files, respectively. Leasehold equities are amortized over the remaining life of the lease. Owned liquor licenses are not amortized, while liquor licenses that must be renewed are amortized over their useful lives. Pharmacy prescription file purchases are amortized over seven years. These assets are considered annually during our testing for impairment.

Store Closing Costs

We provide for closed store liabilities relating to the present value of the estimated remaining noncancellable lease payments after the closing date, net of estimated subtenant income. We estimate the net lease liabilities using a discount rate to calculate the present value of the remaining net rent payments on closed stores. The closed store lease liabilities usually are paid over the lease terms associated with the closed stores, which generally have remaining terms ranging from one to 20 years. Adjustments to closed store liabilities primarily relate to changes in subtenant income and actual exit costs differing from original estimates. Adjustments are made for changes in estimates in the period in which the change becomes known. Store closing liabilities are reviewed quarterly to ensure that any accrued amount that is not a sufficient estimate of future costs, or that no longer is needed for its originally intended purpose, is adjusted to income in the proper period.

We estimate subtenant income, future cash flows and asset recovery values based on our experience and knowledge of the market in which the closed store is located, our previous efforts to dispose of similar assets and current economic conditions. However, the ultimate cost of the disposition of the leases and the related assets is affected by current real estate markets, inflation rates and general economic conditions.

Owned stores held for disposal are reduced to their estimated net realizable value. Costs to reduce the carrying values of property, equipment and leasehold improvements are accounted for in accordance with our policy on impairment of long-lived assets. Inventory write-downs, if any, in connection with store closings, are classified in Merchandise costs. Costs to transfer inventory and equipment from closed stores are expensed as incurred.

Post-Retirement Benefit Plans

(a) Company-sponsored Pension Plans

The determination of our obligation and expense for Company-sponsored pension plans and other post-retirement benefits is dependent upon our selection of assumptions used by actuaries in calculating those amounts. Those assumptions are described in Note 17 to the Consolidated Financial Statements and include, among others, the discount rate, the expected long-term rate of return on plan assets, average life expectancy and the rate of increases in compensation and health care costs. In accordance with Generally Accepted Accounting Principles (GAAP), actual results that differ from our assumptions are accumulated and amortized over future periods and, therefore, generally affect our recognized expense and recorded obligation in future periods. While we believe that our assumptions are appropriate, significant differences in our actual experience or significant changes in our assumptions, including the discount rate used and the expected return on plan assets, may materially affect our pension and other post-retirement obligations and our future expense. Note 17 to the Consolidated Financial Statements discusses the effect of a 1% change in the assumed health care cost trend rate on other post-retirement benefit costs and the related liability.

The objective of our discount rate assumption was to reflect the rate at which the pension benefits could be effectively settled. In making this determination, we took into account the timing and amount of benefits that would be available under the plan. Our methodology for selecting the discount rate as of year-end 2005 was to match the plan s cash flows to that of a yield curve that provides the equivalent yields on zero-coupon corporate bonds for each maturity. Benefit cash flows due in a particular year can be settled theoretically by investing them in the zero-coupon bond that matures in the same year. The discount rate is the single rate that produces the same present value of cash flows. The selection of the 5.70% discount rate as of year-end 2005 represents the equivalent single rate under a broad-market AA yield curve constructed by our outside consultant, Mercer Human Resource Consulting. We utilized a discount rate of 5.75% for year-end 2004. The 5 basis point reduction in the discount rate increased the projected pension benefit obligation as of January 28, 2006, by approximately $12 million.

To determine the expected return on pension plan assets, we consider current and forecasted plan asset allocations as well as historical and forecasted returns on various asset categories. For 2005, we assumed a pension plan investment return rate of 8.5%, consistent with 2004. Our pension plan s average return was 9.6% for the 10 calendar years ended December 31, 2005, net of all investment management fees and expenses. Our actual return for the pension plan calendar year ending December 31, 2005, on that same basis, was 10.3%. We believe the pension return assumption is appropriate because we do not expect that future returns will achieve the same level of performance as the historical average annual return. We have been advised that during 2006 and 2007, the trustees plan to reduce from 61% to 42% the allocation of pension plan assets to domestic and international equities and increase from 12% to 30% the allocation to non-core assets, including inflation-linked bonds, commodities, hedge funds and real estate. Furthermore, in order to augment the return on domestic equities and investment grade debt securities during 2006 and 2007, the trustees plan to increase hedge funds within these sectors from 3% to 15%. Collectively, these changes should improve the diversification of pension plan assets. The trustees expect these changes to have little effect on the total return but will reduce the expected volatility of the return. See Note 17 to the Consolidated Financial Statements for more information on the asset allocations of pension plan assets.

Sensitivity to changes in the major assumptions used in the calculation of Kroger s pension plan liabilities for the Qualified Plans is illustrated below (in millions).

	Percentage Point Change	Projected Benefit Obligation Decrease/(Increase)	Expense Decrease/(Increase)
Discount Rate	+/- 1.0%	$ 277/($315)	$ 27/($33)
Expected Return on Assets	+/- 1.0%		$ 15/($15)

In 2005, we updated the mortality table used to determine average life expectancy in the calculation of our pension obligation to the RP-2000 Projected to 2015 mortality table. The change in this assumption increased our projected benefit obligation approximately $93 million and is reflected in unrecognized actuarial (gain) loss as of the measurement date.

We contributed $300 million, $35 million and $100 million to our Company-sponsored pension plans in 2005, 2004 and 2003, respectively. Although we are not required to make cash contributions to our Company-sponsored pension plans during fiscal 2006, we made a $150 million cash contribution to our qualified pension plans on March 27, 2006. Additional contributions may be made if our cash flows from operations exceed our expectations. We expect any elective contributions made during 2006 will decrease our required contributions in future years. Among other things, investment performance of plan assets, the interest rates required to be used to calculate the pension obligations, and future changes in legislation, will determine the amounts of any additional contributions.

(b) Multi-Employer Plans

We also contribute to various multi-employer pension plans based on obligations arising from most of our collective bargaining agreements. These plans provide retirement benefits to participants based on their service to contributing employers. The benefits are paid from assets held in trust for that purpose. Trustees are appointed in equal number by employers and unions. The trustees typically are responsible for determining the level of benefits to be provided to participants as well as for such matters as the investment of the assets and the administration of the plans.

We recognize expense in connection with these plans as contributions are funded, in accordance with GAAP. We made contributions to these plans, and recognized expense, of $196 million in 2005, $180 million in 2004, and $169 million in 2003. We estimate we would have contributed an additional $2 million in 2004 and $13 million in 2003, but our obligation to contribute was suspended during the southern California and West Virginia labor disputes.

Based on the most recent information available to us, we believe that the present value of actuarial accrued liabilities in most or all of these multi-employer plans substantially exceeds the value of the assets held in trust to pay benefits. We have attempted to estimate the amount by which these liabilities exceed the assets, i.e., the amount of underfunding, as of December 31, 2005. Because Kroger is only one of a number of employers contributing to these plans, we also have attempted to estimate the ratio of Kroger s contributions to the total of all contributions to these plans in a year as a way of assessing Kroger s share of the underfunding. As of December 31, 2005, we estimate that Kroger s share of the underfunding of multi-employer plans to which Kroger contributes was $1.0 to $1.3 billion, pre-tax, or $625 million to $813 million, after-tax. This is consistent with the amount of underfunding estimated as of December 31, 2004. Our estimate is based on the best information available to us including actuarial evaluations and other data (that include the estimates of others), and such information may be outdated or otherwise unreliable. Our estimate is imprecise and not necessarily reliable.

We have made and disclosed this estimate not because this underfunding is a direct liability of Kroger. Rather, we believe the underfunding is likely to have important consequences. We expect our contributions to these multi-employer plans will continue to increase each year, and therefore the expense we recognize under GAAP will increase. In 2005, our contributions to these plans increased approximately 9% over the prior year. We expect our contributions to increase by approximately five percent in 2006 and each year thereafter. The amount of increases in 2006 and beyond has been favorably affected by the labor agreements negotiated in southern California and elsewhere during 2005 and 2004, as well as by related trustee actions. Although underfunding can result in the imposition of excise taxes on contributing employers, increased contributions can reduce underfunding so that excise taxes are not triggered. Our estimate of future contribution increases takes into account the avoidance of those taxes. Finally, underfunding means that, in the event we were to exit certain markets or otherwise cease making contributions to these funds, we could trigger a substantial withdrawal liability. Any adjustment for withdrawal liability will be recorded when it is probable that a liability exists and can be reasonably estimated, in accordance with SFAS No. 87, *Employer s Accounting for Pensions*.

The amount of underfunding described above is an estimate and is disclosed for the purpose described. The amount could decline, and Kroger s future expense would be favorably affected, if the values of net assets held in the trust significantly increase or if further changes occur through collective bargaining, trustee action or favorable legislation. On the other hand, Kroger s share of the underfunding would increase and Kroger s future expense could be adversely affected if net asset values decline, if employers currently contributing to these funds cease participation or if changes occur through collective bargaining, trustee action or adverse legislation.

Deferred Rent

We recognize rent holidays, including the time period during which we have access to the property for construction of buildings or improvements, as well as construction allowances and escalating rent provisions on a straight-line basis over the term of the lease. The deferred amount is included in Other Current Liabilities and Other Long-Term Liabilities on the Consolidated Balance Sheets.

Tax Contingencies

Various taxing authorities periodically audit our income tax returns. These audits include questions regarding our tax filing positions, including the timing and amount of deductions and the allocation of income to various tax jurisdictions. In evaluating the exposures connected with these various tax filing positions, including state and local taxes, we record allowances for probable exposures. A number of years may elapse before a particular matter, for which we have established an allowance, is audited and fully resolved. As of January 28, 2006, tax years 2002 through 2004 were undergoing examination by the Internal Revenue Service.

The establishment of our tax contingency allowances relies on the judgment of management to estimate the exposures associated with our various filing positions. Although management believes those estimates and judgments are reasonable, actual results could differ, resulting in gains or losses that may be material to our Consolidated Statements of Operations.

To the extent that we prevail in matters for which allowances have been established, or are required to pay amounts in excess of these allowances, our effective tax rate in any given financial statement period could be materially affected. An unfavorable tax settlement could require use of cash and result in an increase in our effective tax rate in the year of resolution. A favorable tax settlement would be recognized as a reduction in our effective tax rate in the year of resolution.

Stock Option Plans

We apply Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees,* and related interpretations in accounting for our stock option plans. Accordingly, because the exercise price of the option granted equals the market value of the underlying stock on the option grant date, no stock-based compensation expense is included in net earnings, other than expenses related to restricted stock awards. Notes 1 and 12 to the Consolidated Financial Statements describe the effect on net earnings if compensation cost for all options had been determined based on the fair market value at the grant date for awards, consistent with the methodology prescribed under SFAS No. 123, *Accounting for Stock-Based Compensation.*

In December 2004, the FASB issued SFAS No. 123 (Revised 2004), *Share-Based Payment* (SFAS No. 123R), which replaces SFAS No. 123, supersedes APB No. 25 and related interpretations and amends SFAS No. 95*, Statement of Cash Flows*. The provisions of SFAS No. 123R are similar to those of SFAS No. 123; however, SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements as compensation cost based on their fair value on the date of grant. Fair value of share-based awards will be determined using option pricing models (e.g., Black-Scholes or binomial models) and assumptions that appropriately reflect the specific circumstances of the awards. Compensation cost will be recognized over the vesting period based on the fair value of awards that actually vest. We expect to adopt SFAS No. the adoption of SFAS No. 123R to reduce net earnings by $0.05-$0.06 per diluted share during fiscal 2006.

Inventories

Inventories are stated at the lower of cost (principally on a LIFO basis) or market. In total, approximately 98% of inventories for 2005 and 2004, respectively, were valued using the LIFO method. Cost for the balance of the inventories was determined using the first-in, first-out ("FIFO") method. Replacement cost was higher than the carrying amount by $400 million at January 28, 2006, and by $373 million at January 29, 2005. We follow the Link-Chain, Dollar-Value LIFO method for purposes of calculating our LIFO charge or credit.

The item-cost method of accounting to determine inventory cost before the LIFO adjustment is followed for substantially all store inventories at our supermarket divisions. This method involves counting each item in inventory, assigning costs to each of these items based on the actual purchase costs (net of vendor allowances and cash discounts) of each item and recording the actual cost of items sold. The item-cost method of accounting allows for more accurate reporting of periodic inventory balances and enables management to more precisely manage inventory and purchasing levels when compared to the methodology followed under the retail method of accounting.

We evaluate inventory shortages throughout the year based on actual physical counts in our facilities. We record allowances for inventory shortages based on the results of recent physical counts to provide for estimated shortages from the last physical count to the financial statement date.

Vendor Allowances

We recognize all vendor allowances as a reduction in merchandise costs when the related product is sold. In most cases, vendor allowances are applied to the related product by item, and therefore reduce the carrying value of inventory by item. When it is not practicable to allocate vendor allowances to the product by item, vendor allowances are recognized as a reduction in merchandise costs based on inventory turns and recognized as the product is sold. In fiscal 2005 and 2004, we recognized approximately $3.2 billion and $3.1 billion, respectively, of vendor allowances as a reduction in merchandise costs. More than 80% of all vendor allowances were recognized in the item cost with the remainder being based on inventory turns.

Liquidity and Capital Resources

Cash Flow Information

Net cash provided by operating activities

We generated $2,192 million of cash from operations in 2005 compared to $2,330 million in 2004 and $2,215 million in 2003. In addition to changes in net earnings, changes in our operating assets and liabilities also affect the amount of cash provided by our operating activities. During 2005, we realized a $128 million increase in cash from changes in operating assets and liabilities, compared to a $103 and $247 million decrease during 2004 and 2003, respectively. These amounts are net of cash contributions to our Company-sponsored pension plan totaling $300 million in 2005, $35 million in 2004 and $100 million in 2003.

The amount of cash paid for income taxes in 2005 was higher than the amounts paid in 2004 and 2003 due to higher net earnings. In addition, the bonus depreciation provision, which expired in December 2004, reduced our cash taxes in 2004 and 2003. This benefit reversed in 2005. This provision increased our cash taxes by approximately $108 million in 2005 and reduced our cash taxes by approximately $90 million and $122 million in 2004 and 2003, respectively.

Net cash used by investing activities

Cash used by investing activities was $1,279 million in 2005, compared to $1,608 million in 2004 and $2,026 million in 2003. The amount of cash used by investing activities decreased in 2005 and 2004 due to reduced capital expenditures. Refer to the Capital Expenditures section for an overview of our supermarket storing activity during the last three years.

Net cash used by financing activities

Financing activities used $847 million of cash in 2005 compared to $737 million in 2004 and $201 million in 2003. The increase in cash used by financing in 2005 was due to a decrease in long-term debt issuances. The increases in 2005 and 2004 over 2003 are primarily due to the amount of cash used to reduce our outstanding debt.

Debt Management

Total debt, including both the current and long-term portions of capital leases and financing obligations, decreased $739 million to $7.2 billion as of year-end 2005 from $8.0 billion as of year-end 2004. Total debt decreased $393 million to $8.0 billion as of year-end 2004 from $8.4 billion as of year-end 2003. The decreases were primarily the result of using cash flow from operations to reduce outstanding debt.

Our total debt balances were also affected by our prefunding of employee benefit costs and by the mark-to-market adjustments necessary to record fair value interest rate hedges of our fixed rate debt, pursuant to SFAS No. 133. We had prefunded employee benefit costs of $300 million at year-end 2005, 2004 and 2003. The mark-to-market adjustments increased the carrying value of our debt by $27 million, $70 million and $104 million as of year-end 2005, 2004 and 2003, respectively.

Factors Affecting Liquidity

We currently borrow on a daily basis approximately $15 million under our F2/P2/A3 rated commercial paper (CP) program. These borrowings are backed by our credit facilities, and reduce the amount we can borrow under the credit facilities. We have capacity available under our credit facilities to backstop all CP amounts outstanding. If our credit rating declined below its current level of BBB/ Baa2/BBB-, the ability to borrow under our current CP program could be adversely affected for a period of time immediately following the reduction of our credit rating. This could require us to borrow additional funds under the credit facilities, under which we believe we have sufficient capacity. Borrowings under the credit facilities may be more costly than the money we borrow under our current CP program, depending on the current interest rate environment. However, in the event of a ratings decline, we do not anticipate that access to the CP markets currently available to us would be significantly limited for an extended period of time (i.e., in excess of 30 days). Although our ability to borrow under the credit facilities is not affected by our credit rating, the interest cost on borrowings under the credit facilities would be affected by a decrease in our credit rating or a decrease in our Applicable Percentage Ratio.

Our credit facilities also require the maintenance of a Leverage Ratio and a Fixed Charge Coverage Ratio (our financial covenants). A failure to maintain our financial covenants would impair our ability to borrow under the credit facilities. These financial covenants and ratios are described below:

Our Applicable Percentage Ratio (the ratio of Consolidated EBITDA to Consolidated Total Interest Expense, as defined in the credit facilities) was 6.70 to 1 as of January 28, 2006. If this ratio declined to below 4.75 to 1, the cost of our borrowings under the credit facilities would increase at least 0.13%. The cost of our borrowings under the credit facilities would be similarly affected by a one-level downgrade in our credit rating.

Our Leverage Ratio (the ratio of Net Debt to Consolidated EBITDA, as defined in the credit facilities) was 2.23 to 1 as of January 28, 2006. If this ratio exceeded 3.50 to 1, we would be in default of our credit facilities and our ability to borrow under these facilities would be impaired.

Our Fixed Charge Coverage Ratio (the ratio of Consolidated EBITDA plus Consolidated Rental Expense to Consolidated Cash Interest Expense plus Consolidated Rental Expense, as defined in the credit facilities) was 3.38 to 1 as of January 28, 2006. If this ratio fell below 1.70 to 1, we would be in default of our credit facilities and our ability to borrow under these facilities would be impaired.

Consolidated EBITDA, as defined in our credit facilities, includes an adjustment for unusual gains and losses. Our credit agreements are more particularly described in Note 7 to the Consolidated Financial Statements. We were in compliance with our financial covenants at year-end 2005.

The tables below illustrate our significant contractual obligations and other commercial commitments, based on year of maturity or settlement, as of January 28, 2006 (in millions of dollars):

	2006	2007	2008	2009	2010	Thereafter	Total
Contractual Obligations							
Long-term debt	$ 527	$ 527	$ 1,000	$ 912	$ 42	$ 3,739	$ 6,747
Interest on long-term debt[(1)]	480	423	329	303	250	1,922	3,707
Capital lease obligations	61	57	54	52	51	344	619
Operating lease obligations	784	732	684	635	588	4,075	7,498
Charitable contributions	14						14
Minimum contributions to Company-sponsored pension plans							
Low-income housing obligations	47	6	2				55
Financed lease obligations	11	11	11	11	11	159	214
Construction commitments	95						95
Purchase obligations	362	60	18	5	1		446
Total	$ 2,381	$ 1,816	$ 2,098	$ 1,918	$ 943	$ 10,239	$ 19,395
Other Commercial Commitments							
Credit facilities	$	$	$	$	$	$	$
Standby letters of credit	314						314
Surety bonds	106						106
Guarantees	11						11