

KROGER CO
Form 10-Q
December 11, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended November 3, 2012

OR

- 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

(Exact name of registrant as specified in its charter)

Ohio
(State or other jurisdiction of
incorporation or organization)

31-0345740
(I.R.S. Employer
Identification No.)

1014 Vine Street, Cincinnati, OH 45202
(Address of principal executive offices)
(Zip Code)

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

Unchanged
(Former name, former address and former fiscal year, if changed since last report)

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 the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(do not check if a smaller reporting company)

Edgar Filing: KROGER CO - Form 10-Q

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No .

There were 518,433,851 shares of Common Stock (\$1 par value) outstanding as of December 7, 2012.

PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

THE KROGER CO.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in millions, except per share amounts)

(unaudited)

	Third Quarter Ended		Three Quarters Ended	
	November 3, 2012	November 5, 2011	November 3, 2012	November 5, 2011
Sales	\$ 21,807	\$ 20,594	\$ 72,598	\$ 68,969
Merchandise costs, including advertising, warehousing, and transportation, excluding items shown separately below	17,383	16,358	57,757	54,539
Operating, general and administrative	3,305	3,318	11,161	11,006
Rent	141	141	471	475
Depreciation and amortization	382	372	1,265	1,246
Operating profit	596	405	1,944	1,703
Interest expense	103	99	350	334
Earnings before income tax expense	493	306	1,594	1,369
Income tax expense	175	108	555	468
Net earnings including noncontrolling interests	318	198	1,039	901
Net earnings (loss) attributable to noncontrolling interests	1	2	4	(8)
Net earnings attributable to The Kroger Co.	\$ 317	\$ 196	\$ 1,035	\$ 909
Net earnings attributable to The Kroger Co. per basic common share	\$ 0.61	\$ 0.33	\$ 1.90	\$ 1.51
Average number of common shares used in basic calculation	518	583	539	597
Net earnings attributable to The Kroger Co. per diluted common share	\$ 0.60	\$ 0.33	\$ 1.89	\$ 1.50
Average number of common shares used in diluted calculation	522	586	543	601
Dividends declared per common share	\$ 0.15	\$ 0.115	\$ 0.38	\$ 0.325

The accompanying notes are an integral part of the Consolidated Financial Statements.

THE KROGER CO.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in millions and unaudited)

	Third Quarter Ended		Three Quarters Ended	
	November 3, 2012	November 5, 2011	November 3, 2012	November 5, 2011
Net earnings including noncontrolling interests	\$ 318	\$ 198	\$ 1,039	\$ 901
Other comprehensive income				
Unrealized gain on available for sale securities, net of income tax(1)				2
Amortization of amounts included in net periodic pension expense, net of income tax(2)	13	8	44	28
Unrealized gain (loss) on cash flow hedging activities, net of income tax(3)	3	(8)	(11)	(8)
Amortization of unrealized gains and losses on cash flow hedging activities, net of income tax(4)	1		3	1
Total other comprehensive income	17		36	23
Comprehensive income	335	198	1,075	924
Comprehensive income (loss) attributable to noncontrolling interests	1	2	4	(8)
Comprehensive income attributable to The Kroger Co.	\$ 334	\$ 196	\$ 1,071	\$ 932

(1) Amount is net of tax of \$1 for the first three quarters of 2011.

(2) Amount is net of tax of \$8 for the third quarter of 2012 and \$5 for the third quarter of 2011. Amount is net of tax of \$27 for the first three quarters of 2012 and \$17 for the first three quarters of 2011.

(3) Amount is net of tax of \$2 for the third quarter of 2012 and \$(5) for the third quarter of 2011. Amount is net of tax of \$(7) for the first three quarters of 2012 and \$(5) for the first three quarters of 2011.

(4) Amount is net of tax of \$1 for the first three quarters of 2011.

The accompanying notes are an integral part of the Consolidated Financial Statements.

THE KROGER CO.

CONSOLIDATED BALANCE SHEETS

(in millions, except per share amounts)

(unaudited)

	November 3, 2012	January 28, 2012
ASSETS		
Current assets		
Cash and temporary cash investments	\$ 435	\$ 188
Deposits in-transit	920	786
Receivables	1,039	949
FIFO inventory	6,689	6,157
LIFO reserve	(1,139)	(1,043)
Prepaid and other current assets	333	288
Total current assets	8,277	7,325
Property, plant and equipment, net	14,690	14,464
Goodwill	1,164	1,138
Other assets	527	549
Total Assets	\$ 24,658	\$ 23,476
LIABILITIES		
Current liabilities		
Current portion of long-term debt including obligations under capital leases and financing obligations	\$ 2,079	\$ 1,315
Trade accounts payable	4,825	4,329
Accrued salaries and wages	906	1,056
Deferred income taxes	190	190
Other current liabilities	2,548	2,215
Total current liabilities	10,548	9,105
Long-term debt including obligations under capital leases and financing obligations		
Face-value of long-term debt including obligations under capital leases and financing obligations	6,773	6,826
Adjustment to reflect fair-value interest rate hedges	7	24
Long-term debt including obligations under capital leases and financing obligations	6,780	6,850
Deferred income taxes	771	647
Pension and postretirement benefit obligations	1,380	1,393
Other long-term liabilities	1,417	1,515
Total Liabilities	20,896	19,510
Commitments and contingencies (see Note 7)		
SHAREOWNERS EQUITY		
Preferred shares, \$100 per share, 5 shares authorized and unissued	—	—
Common shares, \$1 par per share, 1,000 shares authorized; 959 shares issued in 2012 and 2011	959	959
Additional paid-in capital	3,434	3,427

Edgar Filing: KROGER CO - Form 10-Q

Accumulated other comprehensive loss	(808)	(844)
Accumulated earnings	9,404	8,571
Common shares in treasury, at cost, 445 shares in 2012 and 398 shares in 2011	(9,228)	(8,132)
Total Shareowners Equity - The Kroger Co.	3,761	3,981
Noncontrolling interests	1	(15)
Total Equity	3,762	3,966
Total Liabilities and Equity	\$ 24,658	\$ 23,476

The accompanying notes are an integral part of the Consolidated Financial Statements.

THE KROGER CO.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions and unaudited)

	Three Quarters Ended	
	November 3, 2012	November 5, 2011
Cash Flows from Operating Activities:		
Net earnings including noncontrolling interests	\$ 1,039	\$ 901
Adjustments to reconcile net earnings including noncontrolling interests to net cash provided by operating activities:		
Depreciation and amortization	1,265	1,246
LIFO charge	96	142
Stock-based employee compensation	61	62
Expense for Company-sponsored pension plans	68	54
Deferred income taxes	130	314
Other	33	54
Changes in operating assets and liabilities net of effects from acquisitions of businesses:		
Store deposits in-transit	(134)	(213)
Receivables	(131)	21
FIFO Inventories	(531)	(681)
Prepaid expenses	(32)	(22)
Trade accounts payable	380	452
Accrued expenses	63	240
Income taxes receivable and payable	115	(111)
Contribution to Company-sponsored pension plans	(37)	(52)
Other	(117)	3
Net cash provided by operating activities	2,268	2,410
Cash Flows from Investing Activities:		
Payments for capital expenditures	(1,471)	(1,405)
Proceeds from sale of assets	23	43
Payments for acquisitions	(12)	(51)
Other	(28)	(6)
Net cash used by investing activities	(1,488)	(1,419)
Cash Flows from Financing Activities:		
Proceeds from issuance of long-term debt	850	3
Dividends paid	(189)	(191)
Payments on long-term debt	(921)	(542)
Net borrowings on commercial paper / credit facility	744	330
Excess tax benefits on stock-based awards	5	6
Proceeds from issuance of capital stock	72	93
Treasury stock purchases	(1,204)	(1,274)
Net increase (decrease) in book overdrafts	115	(25)
Other	(5)	
Net cash used by financing activities	(533)	(1,600)
Net increase (decrease) in cash and temporary cash investments	247	(609)
Cash and temporary cash investments:		

Edgar Filing: KROGER CO - Form 10-Q

Beginning of year		188		825
End of quarter	\$	435	\$	216
Reconciliation of capital expenditures:				
Payments for capital expenditures	\$	(1,471)	\$	(1,405)
Changes in construction-in-progress payables		(11)		(124)
Total capital expenditures	\$	(1,482)	\$	(1,529)
Disclosure of cash flow information:				
Cash paid during the year for interest	\$	320	\$	339
Cash paid during the year for income taxes	\$	334	\$	295

The accompanying notes are an integral part of the Consolidated Financial Statements.

THE KROGER CO.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREOWNERS EQUITY

(in millions, except per share amounts)

(unaudited)

	Common Stock		Additional	Treasury Stock		Accumulated	Accumulated	Noncontrolling	Total
	Shares	Amount	Paid-In	Shares	Amount	Other	Earnings	Interest	
			Capital			Comprehensive			
						Gain (Loss)			
Balances at January 29, 2011	959	\$ 959	\$ 3,394	339	\$ (6,732)	\$ (550)	\$ 8,225	\$ 2	\$ 5,298
Issuance of common stock:									
Stock options exercised				(5)	93				93
Restricted stock issued			(53)	(2)	33				(20)
Treasury stock activity:									
Treasury stock purchases, at cost				51	(1,173)				(1,173)
Stock options exchanged				4	(101)				(101)
Share-based employee compensation			62						62
Other comprehensive gain net of income tax of \$14						23			23
Other			15		(7)			(2)	6
Cash dividends declared (\$0.325 per common share)							(190)		(190)
Net earnings including noncontrolling interests							909	(8)	901
Balances at November 5, 2011	959	\$ 959	\$ 3,418	387	\$ (7,887)	\$ (527)	\$ 8,944	\$ (8)	\$ 4,899
Balances at January 28, 2012	959	\$ 959	\$ 3,427	398	\$ (8,132)	\$ (844)	\$ 8,571	\$ (15)	\$ 3,966
Issuance of common stock:									
Stock options exercised				(4)	72				72
Restricted stock issued			(57)	(2)	38				(19)
Treasury stock activity:									
Treasury stock purchases, at cost				50	(1,137)				(1,137)
Stock options exchanged				3	(67)				(67)
Share-based employee compensation			61						61
Other comprehensive gain net of income tax of \$20						36			36
Other			3		(2)			12	13
Cash dividends declared (\$0.38 per common share)							(202)		(202)

Edgar Filing: KROGER CO - Form 10-Q

share)

Net earnings including noncontrolling interests							1,035	4	1,039
---	--	--	--	--	--	--	-------	---	-------

Balances at November 3, 2012	959	\$	959	\$	3,434	445	\$	(9,228)	\$	(808)	\$	9,404	\$	1	\$	3,762
------------------------------	-----	----	-----	----	-------	-----	----	---------	----	-------	----	-------	----	---	----	-------

The accompanying notes are an integral part of the consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

All amounts in the notes to Consolidated Financial Statements are in millions except per share amounts.

Certain prior-year amounts have been reclassified to conform to current-year presentation.

1. ACCOUNTING POLICIES

Basis of Presentation and Principles of Consolidation

The accompanying financial statements include the consolidated accounts of The Kroger Co., its wholly-owned subsidiaries, and the Variable Interest Entities (VIEs) in which the Company is the primary beneficiary. The January 28, 2012 balance sheet was derived from audited financial statements and, due to its summary nature, does not include all disclosures required by generally accepted accounting principles (GAAP). Significant intercompany transactions and balances have been eliminated. References to the Company in these Consolidated Financial Statements mean the consolidated company.

In the opinion of management, the accompanying unaudited Consolidated Financial Statements include all normal, recurring adjustments that are necessary for a fair presentation of results of operations for such periods but should not be considered as indicative of results for a full year. The financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been omitted, pursuant to SEC regulations. Accordingly, the accompanying Consolidated Financial Statements should be read in conjunction with the financial statements in the Annual Report on Form 10-K of The Kroger Co. for the fiscal year ended January 28, 2012.

The unaudited information in the Consolidated Financial Statements for the third quarter and the three quarters ended November 3, 2012 and November 5, 2011, includes the results of operations of the Company for the 12 and 40-week periods then ended.

2. STOCK OPTION PLANS

The Company recognized total stock-based compensation of \$20 and \$18 in the third quarters ended November 3, 2012 and November 5, 2011, respectively. The Company recognized total stock-based compensation of \$61 and \$62 in the first three quarters of 2012 and 2011, respectively. These costs were recognized as operating, general and administrative costs in the Company's Consolidated Statements of Operations.

Edgar Filing: KROGER CO - Form 10-Q

The Company grants options for common shares (stock options) to employees, as well as to its non-employee directors, under various plans at an option price equal to the fair market value of the shares at the date of grant. In addition to stock options, the Company awards restricted stock to employees and its non-employee directors under various plans. Equity awards may be made once each quarter on a predetermined date. It has been the Company s practice to make a general annual grant to employees, which occurred in the second quarter of 2012. Special grants may be made in the other three quarters. Grants to non-employee directors occur on the same date that the general annual grant to employees occurs.

Stock options granted in the first three quarters of 2012 expire 10 years from the date of grant and vest between one year and five years from the date of grant. Restricted stock awards granted in the first three quarters of 2012 have restrictions that lapse between one year and five years from the date of the awards. All grants and awards become immediately exercisable, in the case of options, and restrictions lapse, in the case of restricted stock, upon certain changes of control of the Company.

Changes in equity awards outstanding under the plans are summarized below.

Stock Options

	Shares subject to option		Weighted-average exercise price
Outstanding, January 28, 2012	31.0	\$	21.80
Granted	4.0	\$	21.99
Exercised	(4.1)	\$	18.72
Canceled or Expired	(1.8)	\$	23.50
Outstanding, November 3, 2012	29.1	\$	22.16

Restricted Stock

	Restricted shares outstanding		Weighted-average grant-date fair value
Outstanding, January 28, 2012	4.2	\$	23.92
Granted	2.5	\$	22.02
Lapsed	(2.3)	\$	24.44
Canceled or Expired	(0.1)	\$	23.42
Outstanding, November 3, 2012	4.3	\$	22.55

The weighted-average fair value of stock options granted during the first three quarters ended November 3, 2012 and November 5, 2011, was \$4.37 and \$6.00, respectively. The fair value of each stock option grant was estimated on the date of grant using the Black-Scholes option-pricing model, based on the assumptions shown in the table below. The Black-Scholes model utilizes extensive accounting judgment and financial estimates, including the term employees are expected to retain their stock options before exercising them, the volatility of the Company's stock price over that expected term, the dividend yield over the term, and the number of awards expected to be forfeited before they vest. Using alternative assumptions in the calculation of fair value would produce fair values for stock option grants that could be different than those used to record stock-based compensation expense in the Consolidated Statements of Operations.

The following table reflects the weighted average assumptions used for grants awarded to option holders:

	2012	2011
Risk-free interest rate	0.97%	2.16%
Expected dividend yield	2.49%	1.90%
Expected volatility	26.49%	26.31%
Expected term	6.9 Years	6.9 Years

3. DEBT OBLIGATIONS

Long-term debt consists of:

	November 3, 2012	January 28, 2012
2.20% to 8.00% Senior Notes due through 2042	\$ 7,087	\$ 7,078
5.00% to 12.75% Mortgages due in varying amounts through 2034	61	65
Commercial paper borrowings	114	370
Credit facility borrowings	1,000	
Other	179	230
Total debt, excluding capital leases and financing obligations	8,441	7,743
Less current portion	(2,037)	(1,275)
Total long-term debt, excluding capital leases and financing obligations	\$ 6,404	\$ 6,468

In the first quarter of 2012, the Company issued \$500 of senior notes due in fiscal year 2022 bearing an interest rate of 3.40% and \$350 of senior notes due in fiscal year 2042 bearing an interest rate of 5.00%. In the first quarter of 2012, the Company repaid upon their maturity \$491 of senior notes bearing an interest rate of 6.75%.

In the second quarter of 2012, the Company repaid upon their maturity \$346 of senior notes bearing an interest rate of 6.20%.

During the last week of the third quarter of 2012, the Company borrowed \$1 billion under its credit facility to meet short-term funding needs during the storm on the East coast of the United States as a precaution against a potential concern that commercial paper purchasers would have limited access to their facilities and systems. The Company repaid these borrowings during the first week of the fourth quarter of 2012.

4. BENEFIT PLANS

The following table provides the components of net periodic benefit costs for the Company-sponsored defined benefit pension plans and other post-retirement benefit plans for the third quarters of 2012 and 2011.

	Third Quarter Ended			
	Pension Benefits		Other Benefits	
	November 3, 2012	November 5, 2011	November 3, 2012	November 5, 2011
Components of net periodic benefit cost:				
Service cost	\$ 11	\$ 8	\$ 4	\$ 4
Interest cost	36	36	3	3

Edgar Filing: KROGER CO - Form 10-Q

Expected return on plan assets	(49)	(48)		
Amortization of:				
Prior service cost			(1)	(1)
Actuarial loss	22	14		
Net periodic benefit cost	\$ 20	\$ 10	\$ 6	\$ 6

Edgar Filing: KROGER CO - Form 10-Q

The following table provides the components of net periodic benefit costs for the Company-sponsored defined benefit pension plans and other post-retirement benefit plans for the first three quarters of 2012 and 2011.

	Three Quarters Ended			
	Pension Benefits		Other Benefits	
	November 3, 2012	November 5, 2011	November 3, 2012	November 5, 2011
Components of net periodic benefit cost:				
Service cost	\$ 36	\$ 34	\$ 13	\$ 11
Interest cost	120	128	12	13
Expected return on plan assets	(162)	(158)		
Amortization of:				
Prior service cost			(3)	(4)
Actuarial loss	74	50		(1)
Net periodic benefit cost	\$ 68	\$ 54	\$ 22	\$ 19

The Company contributed \$37 and \$52 to its Company-sponsored defined benefit pension plans in the first three quarters of 2012 and 2011, respectively. For 2012, the Company expects to contribute approximately \$75 in total to these plans.

The Company contributed \$110 and \$101 to employee 401(k) retirement savings accounts in the first three quarters of 2012 and 2011, respectively.

The Company also contributes to various multi-employer pension plans based on obligations arising from most of its collective bargaining agreements. These plans provide retirement benefits to participants based on their service to contributing employers. The Company recognizes expense in connection with these plans as contributions are funded.

5. EARNINGS PER COMMON SHARE

Net earnings attributable to The Kroger Co. per basic common share equal net earnings attributable to The Kroger Co. less income allocated to participating securities divided by the weighted average number of common shares outstanding. Net earnings attributable to The Kroger Co. per diluted common share equal net earnings attributable to The Kroger Co. less income allocated to participating securities divided by the weighted average number of common shares outstanding, after giving effect to dilutive stock options. The following table provides a reconciliation of net earnings attributable to The Kroger Co. and shares used in calculating net earnings attributable to The Kroger Co. per basic common share to those used in calculating net earnings attributable to The Kroger Co. per diluted common share:

	Third Quarter Ended November 3, 2012			Third Quarter Ended November 5, 2011		
	Earnings (Numerator)	Shares (Denominator)	Per Share Amount	Earnings (Numerator)	Shares (Denominator)	Per Share Amount
Net earnings attributable to The Kroger Co. per basic common share	\$ 314	518	\$ 0.61	\$ 194	583	\$ 0.33
Dilutive effect of stock options		4			3	
Net earnings attributable to The Kroger Co. per diluted common share	\$ 314	522	\$ 0.60	\$ 194	586	\$ 0.33
	Three Quarters Ended November 3, 2012			Three Quarters Ended November 5, 2011		
	Earnings (Numerator)	Shares (Denominator)	Per Share Amount	Earnings (Numerator)	Shares (Denominator)	Per Share Amount
Net earnings attributable to The Kroger Co. per basic common share	\$ 1,027	539	\$ 1.90	\$ 903	597	\$ 1.51
Dilutive effect of stock options		4			4	
Net earnings attributable to The Kroger Co. per diluted common share	\$ 1,027	543	\$ 1.89	\$ 903	601	\$ 1.50

The Company had combined undistributed and distributed earnings to participating securities totaling \$3 and \$2 in the third quarters of 2012 and 2011, respectively. The Company had combined undistributed and distributed earnings to participating securities of \$8 and \$6 in the first three quarters of 2012 and 2011, respectively.

The Company had options outstanding for approximately 14 and 17 shares during the third quarters of 2012 and 2011, respectively, that were excluded from the computations of earnings per diluted common share because their inclusion would have had an anti-dilutive effect on earnings per share. The Company had options outstanding for approximately 12 and 13 shares in the first three quarters of 2012 and 2011, respectively, that were excluded from the computations of earnings per diluted common share because their inclusion would have had an anti-dilutive effect on earnings per share.

6. RECENTLY ADOPTED ACCOUNTING STANDARDS

In June 2011, the Financial Accounting Standards Board (FASB) amended its rules regarding the presentation of comprehensive income. The objective of this amendment is to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. Specifically, this amendment requires that all non-owner changes in shareholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The new rules became effective for interim and annual periods beginning after December 15, 2011. In December 2011, the FASB deferred certain aspects of this standard beyond the December 15, 2011 effective date, specifically the provisions dealing with reclassification adjustments. The Company adopted this amended standard effective January 29, 2012 by presenting separate Consolidated Statements of Comprehensive Income immediately following the Consolidated Statements of Operations. Because this standard only affects the display of comprehensive income and does not affect what is included in comprehensive income, this standard did not have a material effect on the Company's Consolidated Financial Statements.

In May 2011, the FASB amended its rules for disclosure requirements for common fair value measurement. These amendments, effective for the interim and annual periods beginning on or after December 15, 2011 (early adoption was prohibited), result in a common definition of fair value and common requirements for fair value measurement and disclosure between GAAP and International Financial Accounting Standards. Consequently, the amendments change some fair value measurement principles and disclosure requirements. The implementation of the amended accounting guidance did not have a material effect on the Company's consolidated financial position or results of operations.

7. COMMITMENTS AND CONTINGENCIES

The Company continuously evaluates contingencies based upon the best available evidence.

The Company believes that allowances for loss have been provided to the extent necessary and that its assessment of contingencies is reasonable. To the extent that resolution of contingencies results in amounts that vary from the Company's estimates, future earnings will be charged or credited.

Litigation On October 6, 2006, the Company petitioned the Tax Court (*Ralphs Grocery Company and Subsidiaries, formerly known as Ralphs Supermarkets, Inc. v. Commissioner of Internal Revenue, Docket No. 20364-06*) for a redetermination of deficiencies asserted by the Commissioner of Internal Revenue. The dispute at issue involved a 1992 transaction in which Ralphs Holding Company acquired the stock of Ralphs Grocery Company and made an election under Section 338(h)(10) of the Internal Revenue Code. The Commissioner determined that the acquisition of the stock was not a purchase as defined by Section 338(h)(3) of the Internal Revenue Code and that the acquisition therefore did not qualify for a Section 338(h)(10) election. On January 27, 2011, the Tax Court issued its opinion upholding the Company's position that the acquisition of the stock qualified as a purchase, granting the Company's motion for partial summary judgment and denying the Tax Commissioner's motion. All remaining issues in the matter had been resolved and the Tax Court entered its decision on May 2, 2012. On July 24, 2012, the Tax Commissioner filed a notice with the United States Court of Appeals for the 9th Circuit to appeal the decision of the Tax Court.

Subsequent to the filing of the notice to appeal the government requested the dismissal of the case. On November 14, 2012, the United States Court of Appeals for the 9th Circuit issued its dismissal order with prejudice, finally resolving all issues in the matter.

Various claims and lawsuits arising in the normal course of business, including suits charging violations of certain antitrust, wage and hour, or 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, results of operations, or cash flows.

The Company continually evaluates its exposure to loss contingencies arising from pending or threatened litigation and believes it has made provisions where it is reasonably possible to estimate and where an adverse outcome is probable. Nonetheless, assessing and predicting the outcomes of these matters involves substantial uncertainties. Management currently believes that the aggregate range of loss for the Company's exposure is not material to the Company. 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 effect on the Company's financial condition, results of operations, or cash flows.

Benefit Plans The Company had \$258 and \$311 accrued as of November 3, 2012 and January 28, 2012, respectively, in other long-term liabilities related to the Company's contractual obligation under the UFCW consolidated pension plan, which resulted from the consolidation of four UFCW multi-employer pension plans into one multi-employer pension plan in the fourth quarter of 2011. The other long-term liability for the Company's contractual obligation under the UFCW consolidated pension plan decreased as of the end of the third quarter of 2012, compared to the end of the fourth quarter of 2011, due to a reduction in the Company's Unfunded Actuarial Accrued Liability estimate. For more information regarding this other long-term liability and the consolidation of the four UFCW multi-employer pension plans into one multi-employer pension plan in the fourth quarter of 2011, please refer to Note 14 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the fiscal year ended January 28, 2012.

8. DERIVATIVE FINANCIAL INSTRUMENTS

GAAP defines derivatives, requires that derivatives be carried at fair value on the balance sheet, and provides for hedge accounting when certain conditions are met. The Company's derivative financial instruments are recognized on the balance sheet at fair value. Changes in the fair value of derivative instruments designated as cash flow hedges, to the extent the hedges are highly effective, are recorded in other comprehensive income, net of tax effects. Ineffective portions of cash flow hedges, if any, are recognized in current period earnings. Other comprehensive income or loss is reclassified into current period earnings when the hedged transaction affects earnings. Changes in the fair value of derivative instruments designated as fair value hedges, along with corresponding changes in the fair values of the hedged assets or liabilities, are recorded in current period earnings. Ineffective portions of fair value hedges, if any, are recognized in current period earnings.

The Company assesses, both at the inception of the hedge and on an ongoing basis, whether derivatives used as hedging instruments are highly effective in offsetting the changes in the fair value or cash flow of the hedged items. If it is determined that a derivative is not highly effective as a hedge or ceases to be highly effective, the Company discontinues hedge accounting prospectively.

Interest Rate Risk Management

The Company is exposed to market risk from fluctuations in interest rates. The Company manages its exposure to interest rate fluctuations through the use of interest rate swaps (fair value hedges) and forward-starting interest rate swaps (cash flow hedges). The Company's current program relative to interest rate protection contemplates hedging the exposure to changes in the fair value of fixed-rate debt attributable to changes in interest rates. To do this, the Company uses the following guidelines: (i) use average daily outstanding borrowings to determine annual debt amounts subject to interest rate exposure, (ii) limit the average annual amount subject to interest rate reset and the amount of floating rate debt to a combined total of \$2,500 or less, (iii) include no leveraged products, and (iv) hedge without regard to profit motive or sensitivity to current mark-to-market status.

Annually, the Company reviews with the Financial Policy Committee of the Board of Directors compliance with these guidelines. These guidelines may change as the Company's needs dictate.

Fair Value Interest Rate Swaps

The table below summarizes the outstanding interest rate swaps designated as fair value hedges as of November 3, 2012 and January 28, 2012.

	November 3, 2012		January 28, 2012	
	Pay Floating	Pay Fixed	Pay Floating	Pay Fixed
Notional amount	\$ 900	\$	\$ 1,625	\$
Number of contracts	10		18	
Duration in years	0.67		0.74	
Average variable rate	3.17%		3.84%	
Average fixed rate	5.36%		5.87%	

Edgar Filing: KROGER CO - Form 10-Q

Maturity

Between February 2013 and December 2018

Between April 2012 and April 2013

During the first three quarters of 2012, nine of the Company's fair value swaps, with a notional amount of \$775, matured.

During the third quarter of 2012, the Company entered into a fair value swap with a notional amount of \$50.

Edgar Filing: KROGER CO - Form 10-Q

The gain or loss on these derivative instruments as well as the offsetting gain or loss on the hedged items attributable to the hedged risk are recognized in current income as Interest expense. These gains and losses for the third quarters and first three quarters of 2012 and 2011 were as follows:

Income Statement Classification	Third Quarter Ended			
	November 3, 2012		November 5, 2011	
	Gain/(Loss) on Swaps	Gain/(Loss) on Borrowings	Gain/(Loss) on Swaps	Gain/(Loss) on Borrowings
Interest Expense	\$ (4)	\$ 4	\$ (7)	\$ 7

Income Statement Classification	Three Quarters Ended			
	November 3, 2012		November 5, 2011	
	Gain/(Loss) on Swaps	Gain/(Loss) on Borrowings	Gain/(Loss) on Swaps	Gain/(Loss) on Borrowings
Interest Expense	\$ (18)	\$ 14	\$ (14)	\$ 16

The following table summarizes the location and fair value of derivative instruments designated as fair value hedges on the Company's Consolidated Balance Sheets:

Derivatives Designated as Fair Value Hedging Instruments	Fair Value		Balance Sheet Location
	Asset Derivatives		
	November 3, 2012	January 28, 2012	
Interest Rate Hedges	\$ 7	\$ 25	Other Assets

Cash Flow Forward-Starting Interest Rate Swaps

As of November 3, 2012, the Company had 17 forward-starting interest rate swap agreements with maturity dates between April 2013 and January 2014 with an aggregate notional amount totaling \$850. In the second quarter of 2012, the Company entered into seven of these forward-starting interest rate swap agreements with an aggregate notional amount totaling \$350. A forward-starting interest rate swap is an agreement that effectively hedges the variability in future benchmark interest payments attributable to changes in interest rates on the forecasted issuance of fixed-rate debt. The Company entered into these forward-starting interest rate swaps in order to lock in fixed interest rates on its forecasted issuances of debt in fiscal year 2013. Accordingly, the forward-starting interest rate swaps were designated as cash-flow hedges as defined by GAAP. As of November 3, 2012, the fair value of the interest rates swaps was recorded in other long-term liabilities for \$32 and accumulated other comprehensive loss for \$20 net of tax.

As of January 28, 2012, the Company had 24 forward-starting interest rate swap agreements with maturity dates between May 2012 and April 2013 with an aggregate notional amount totaling \$1,200. The Company entered into the forward-starting interest rate swaps in order to lock in fixed interest rates on its forecasted issuances of debt in fiscal years 2012 and 2013. Accordingly, the forward-starting interest rate swaps were designated as cash-flow hedges as defined by GAAP. As of January 28, 2012, the fair value of the interest rates swaps was recorded in other long-term liabilities for \$41 and accumulated other comprehensive loss for \$26 net of tax.

During the first three quarters of 2012, the Company terminated 14 forward-starting interest rate swap agreements with maturity dates of May 2012 with an aggregate notional amount totaling \$700. These forward-starting interest rate swap agreements were hedging the variability

Edgar Filing: KROGER CO - Form 10-Q

in future benchmark interest payments attributable to changing interest rates on the forecasted issuance of fixed-rate debt to be issued in the first quarter of 2012. As discussed in Note 3, the Company issued \$850 of senior notes in the first quarter of 2012. Since these forward-starting interest rate swap agreements were classified as cash flow hedges, the unamortized loss of \$27 has been deferred net of tax in accumulated other comprehensive income (AOCI) and will be amortized to earnings as the interest payments are made.

Edgar Filing: KROGER CO - Form 10-Q

The following tables summarize the effect of the Company's derivative instruments designated as cash flow hedges for the third quarters and first three quarters of 2012 and 2011:

Derivatives in Cash Flow Hedging Relationships	Third Quarter Ended				Location of Gain/(Loss) Reclassified into Income (Effective Portion)
	Amount of Gain/(Loss) in AOCI on Derivatives (Effective Portion)		Amount of Gain/(Loss) Reclassified from AOCI into Income (Effective Portion)		
	November 3, 2012	November 5, 2011	November 3, 2012	November 5, 2011	
Forward-Starting Interest Rate Swaps, net of tax*	\$ (39)	\$ (12)	\$ (1)	\$	Interest expense

*The amounts of Gain/(Loss) in AOCI on derivatives include unamortized proceeds and payments from forward-starting interest rate swaps once classified as cash flow hedges that were terminated prior to the third quarter of 2012.

Derivatives in Cash Flow Hedging Relationships	Three Quarters Ended				Location of Gain/(Loss) Reclassified into Income (Effective Portion)
	Amount of Gain/(Loss) in AOCI on Derivatives (Effective Portion)		Amount of Gain/(Loss) Reclassified from AOCI into Income (Effective Portion)		
	November 3, 2012	November 5, 2011	November 3, 2012	November 5, 2011	
Forward-Starting Interest Rate Swaps, net of tax*	\$ (39)	\$ (12)	\$ (3)	\$ (1)	Interest expense

*The amounts of Gain/(Loss) in AOCI on derivatives include unamortized proceeds and payments from forward-starting interest rate swaps once classified as cash flow hedges that were terminated prior to the third quarter of 2012.

Commodity Price Protection

The Company enters into purchase commitments for various resources, including raw materials utilized in its manufacturing facilities and energy to be used in its stores, warehouses, manufacturing facilities and administrative offices. The Company enters into commitments expecting to take delivery of and to utilize those resources in the conduct of normal business. Those commitments for which the Company expects to utilize or take delivery in a reasonable amount of time in the normal course of business qualify as normal purchases and normal sales.

9. FAIR VALUE MEASUREMENTS

GAAP establishes a fair value hierarchy that prioritizes the inputs used to measure fair value. The three levels of the fair value hierarchy defined in the standards are as follows:

Level 1 Quoted prices are available in active markets for identical assets or liabilities;

Edgar Filing: KROGER CO - Form 10-Q

Level 2 Pricing inputs are other than quoted prices in active markets included in Level 1, which are either directly or indirectly observable;

Level 3 Unobservable pricing inputs in which little or no market activity exists, therefore requiring an entity to develop its own assumptions about the assumptions that market participants would use in pricing an asset or liability.

Edgar Filing: KROGER CO - Form 10-Q

For items carried at (or adjusted to) fair value in the consolidated financial statements, the following tables summarize the fair value of these instruments at November 3, 2012 and January 28, 2012:

November 3, 2012 Fair Value Measurements Using

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Available-for-Sale Securities	\$ 8		\$ 20	\$ 28
Long-Lived Assets			4	4
Interest Rate Hedges		(26)		(26)
Total	\$ 8	\$ (26)	\$ 24	\$ 6

January 28, 2012 Fair Value Measurements Using

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Available-for-Sale Securities	\$ 8		\$ 20	\$ 28
Long-Lived Assets			23	23
Interest Rate Hedges		(16)		(16)
Total	\$ 8	\$ (16)	\$ 43	\$ 35

The Company values interest rate hedges using observable forward yield curves. These forward yield curves are classified as Level 2 inputs.

Fair value measurements of non-financial assets and non-financial liabilities are primarily used in the impairment analysis of goodwill, other intangible assets, and long-lived assets, and in the valuation of store lease exit costs. The Company reviews goodwill and other intangible assets for impairment annually, during the fourth quarter of each fiscal year, and as circumstances indicate the possibility of impairment. See Note 2 to the Consolidated Financial Statements in the Annual Report on Form 10-K for the fiscal year ended January 28, 2012 for further discussion related to the Company's carrying value of goodwill. Long-lived assets and store lease exit costs were measured at fair value on a nonrecurring basis using Level 3 inputs as defined in the fair value hierarchy. See Note 1 to the Consolidated Financial Statements in the Annual Report on Form 10-K for the fiscal year ended January 28, 2012 for further discussion of the Company's policies regarding the valuation of long-lived assets and store lease exit costs. For the first three quarters of 2012, long-lived assets with a carrying amount of \$14 were written down to their fair value of \$4 resulting in an impairment charge of \$10. For the first three quarters of 2011, long-lived assets with a carrying amount of \$52 were written down to their fair value of \$22 resulting in an impairment charge of \$30.

For the first three quarters of 2011, the Company recorded unrealized gains on its Level 3 Available-for-Sale Securities in the amount of \$3.

Fair Value of Other Financial Instruments

Current and Long-term Debt

The fair value of the Company's long-term debt, including current maturities, was estimated based on the quoted market prices for the same or similar issues adjusted for illiquidity based on available market evidence. If quoted market prices were not available, the fair value was based on the net present value of the future cash flow using the forward interest rate yield curve in effect at November 3, 2012, and January 28, 2012, which is a Level 3 measurement technique. At November 3, 2012, the fair value of total debt was \$9,546 compared to a carrying value of \$8,441. At January 28, 2012, the fair value of total debt was \$8,700 compared to a carrying value of \$7,743.

Cash and Temporary Cash Investments, Store Deposits In-Transit, Receivables, Prepaid and Other Current Assets, Accounts Payable, Accrued Salaries and Wages and Other Current Liabilities

The carrying amounts of these items approximated fair value.

Long-term Investments

The fair values of these investments were estimated based on quoted market prices for those or similar investments, or estimated cash flows, if appropriate. At November 3, 2012, and January 28, 2012, the carrying and fair value of long-term investments for which fair value is determinable was \$44 and \$50, respectively.

10. INCOME TAXES

The effective income tax rate was 35.5% and 35.3% for the third quarters of 2012 and 2011, respectively. The effective income tax rate was 34.8% and 34.2% for the first three quarters of 2012 and 2011, respectively. The effective tax rate for the third quarters of 2012 and 2011 approximate the federal statutory rate. The effective income tax rate for the first three quarters of 2012 and 2011 differed from the federal statutory rate primarily due to the favorable resolution of certain tax issues, partially offset by the effect of state income taxes.

11. SUBSEQUENT EVENT

During the fourth quarter of 2012, the Company purchased the outstanding shares of Axium Pharmacy, a leading specialty pharmacy that provides specialized drug therapies and support services for patients with complex medical conditions. Offering specialty pharmacy services will give the Company's customers greater access to drugs it doesn't currently dispense and access to additional services the Company does not currently provide.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following analysis should be read in conjunction with the Consolidated Financial Statements.

OVERVIEW

Third quarter 2012 total sales were \$21.8 billion compared with \$20.6 billion for the same period of 2011. This increase was attributable to identical supermarket sales increases, increased fuel gallon sales and an increase in the average retail fuel price. Identical supermarket sales without fuel increased 3.2% in the third quarter of 2012, compared to the third quarter of 2011, primarily due to an increased transaction count, an increase in the number of households shopping with us, an increase in the total units each household purchased and product cost inflation. This marks positive identical supermarket sales growth for 36 consecutive quarters. Every supermarket store department had positive identical sales during the third quarter. Total sales for the first three quarters of 2012 were \$72.6 billion compared with \$69.0 billion for the same period of 2011. This increase was attributable to identical supermarket sales increases, increased fuel gallon sales and an increase in the average retail fuel price. Identical supermarket sales without fuel increased 3.7% in the first three quarters of 2012, compared to the same period in 2011, primarily due to an increased transaction count, an increase in the average sale per shopping trip, an increase in the number of households shopping with us and product cost inflation. Our Customer 1st strategy continues to deliver solid results.

For the third quarter of 2012, net earnings totaled \$317 million, or \$0.60 per diluted share, compared to \$196 million, or \$0.33 per diluted share for the same period of 2011. This includes a \$0.14 per diluted share benefit from a settlement with Visa and MasterCard and from a reduction in our obligation to fund the UFCW consolidated pension fund created in January 2012 (adjusted items). Excluding these adjusted items, net earnings totaled \$243 million, or \$0.46 per diluted share, for the third quarter of 2012. The adjustments for these items resulted in a reduction of operating, general and administrative expense of \$115 million (\$74 million after-tax) in the third quarter of 2012. We believe the adjusted earnings per diluted share figure presents a more accurate year-over-year comparison of our financial results because the adjusted items were not the result of our normal operations. The net earnings and adjusted earnings per diluted share for the third quarter of 2012 also includes a \$0.02 benefit from a lower Last-In, First-Out (LIFO) charge due to the Company reducing its estimated LIFO charge to \$125 million from \$150 million for 2012. For the first three quarters of 2012, net earnings totaled \$1.0 billion, or \$1.89 per diluted share, compared to \$909 million, or \$1.50 per diluted share for the same period of 2011. Excluding the adjusted items, net earnings totaled \$961 million, or \$1.76 per diluted share, for the first three quarters of 2012. Please refer to the Net Earnings section for more information related to the increases in net earnings for both the third quarter and the first three quarters of 2012, compared to the third quarter and the first three quarters of 2011.

Based on our results for the first three quarters of 2012, we have increased both the lower and upper range of our guidance for net earnings per diluted share, excluding the adjusted items, for fiscal year 2012. Please refer to the Outlook section for more information on our expectations. Our Customer 1st strategy continues to increase customer loyalty, identical supermarket sales and market share. As a result, we are rewarding shareholders through net earnings per diluted share growth, increasing dividends over time and share buybacks.

RESULTS OF OPERATIONS

Net Earnings

Edgar Filing: KROGER CO - Form 10-Q

Net earnings totaled \$317 million for the third quarter of 2012, an increase of 61.7% from net earnings of \$196 million for the third quarter of 2011. Net earnings totaled \$243 million, excluding the adjusted items, for the third quarter of 2012, an increase of 24.0% from net earnings of \$196 million for the third quarter of 2011. The increase in our net earnings, excluding the adjusted items, for the third quarter of 2012, compared to the third quarter of 2011, resulted primarily from a decrease in our LIFO charge and increases in FIFO non-fuel operating profit and earnings from our fuel operations. The increase in FIFO non-fuel operating profit, excluding the adjusted items, for the third quarter of 2012, compared to the third quarter of 2011, resulted primarily from increased supermarket sales, productivity improvements, effective cost controls, increased pharmacy results, decreased incentive compensation expense and lower operating expenses resulting from the consolidation of four multi-employer pension plans in the prior year, partially offset by continued investments in lower prices for our customers and increases in health care costs. The increase in earnings from our fuel operations for the third quarter of 2012, compared to the third quarter of 2011, resulted primarily from increases in fuel gallons sold and increases in the margin per gallon of fuel sold.

Edgar Filing: KROGER CO - Form 10-Q

Net earnings totaled \$1.0 billion for the first three quarters of 2012, an increase of 13.9% from net earnings of \$909 million for the first three quarters of 2011. Net earnings, excluding the adjusted items, totaled \$961 million for the first three quarters of 2012, an increase of 5.7% from net earnings of \$909 million for the first three quarters of 2011. The increase in our net earnings, excluding the adjusted items, for the first three quarters of 2012, compared to the same period in 2011, resulted primarily from a decrease in our LIFO charge and increases in FIFO non-fuel operating profit and earnings from our fuel operations, offset partially by an increase in our effective tax rate and interest expense. The increase in FIFO non-fuel operating profit, excluding the adjusted items, for the first three quarters of 2012, compared to the same period in 2011, resulted primarily from the benefit of increased supermarket sales, productivity improvements, effective cost controls, increased pharmacy results, decreased incentive compensation expense and the benefit received in lower operating expenses from the consolidation of four multi-employer pension plans in the prior year, partially offset by continued investments in lower prices for our customers and increases in health care costs. The increase in earnings from our fuel operations for the first three quarters of 2012, compared to the first three quarters of 2011, resulted primarily from increases in fuel gallons sold. Our effective tax rate increased in the first three quarters of 2012, compared to the same period in 2011, primarily due to the favorable resolution of certain tax issues in the second quarter of 2011.

Net earnings of \$0.60 per diluted share for the third quarter of 2012 represented an increase of 81.8% over net earnings of \$0.33 per diluted share for the third quarter of 2011. Net earnings of \$0.46 per diluted share, excluding the adjusted items, for the third quarter of 2012 represented an increase of 39.4% over net earnings of \$0.33 per diluted share for the third quarter of 2011. Net earnings per diluted share, excluding the adjusted items, increased in the third quarter of 2012, compared to the third quarter of 2011, due to increased net earnings and the repurchase of 65 million common shares over the past four quarters resulting in a lower weighted average number of shares outstanding.

Net earnings of \$1.89 per diluted share for the first three quarters of 2012 represented an increase of 26.0% over net earnings of \$1.50 per diluted share for the first three quarters of 2011. Net earnings of \$1.76 per diluted share, excluding the adjusted items, for the first three quarters of 2012 represented an increase of 17.3% over net earnings of \$1.50 per diluted share for the first three quarters of 2011. Net earnings per diluted share, excluding the adjusted items, increased in the first three quarters of 2012, compared to the first three quarters of 2011, due to increased net earnings and the repurchase of 65 million common shares over the past four quarters resulting in a lower weighted average number of shares outstanding.

Management believes adjusted net earnings (and adjusted net earnings per diluted share) are useful metrics to investors and analysts because the amounts referenced above in net earnings and net earnings per diluted share are not directly related to our day-to-day business. Adjusted net earnings (and adjusted net earnings per diluted share) are non-generally accepted accounting principle (non-GAAP) financial measures and should not be considered alternatives to net earnings (and net earnings per diluted share) or any other generally accepted accounting principle (GAAP) measure of performance. Adjusted net earnings (and adjusted net earnings per diluted share) should not be reviewed in isolation or considered substitutes for our financial results as reported in accordance with GAAP. Management uses adjusted earnings (and adjusted net earnings per diluted share) as it believes these measures are more meaningful indicators of operating performance since, as adjusted, those earnings relate more directly to our day-to-day operations. Management also uses adjusted earnings (and adjusted net earnings per diluted share) as a performance metric for management incentive programs, and to measure our progress against internal budgets and targets.

Sales

Total Sales

(in millions)

Third Quarter Ended

Three Quarters Ended

Edgar Filing: KROGER CO - Form 10-Q

	November 3, 2012	Percentage Increase	November 5, 2011	Percentage Increase(2)	November 3, 2012	Percentage Increase	November 5, 2011	Percentage Increase(3)
Total supermarket sales without fuel	\$ 16,716	3.6%	\$ 16,135	5.1%	\$ 56,066	3.9%	\$ 53,944	5.0%
Fuel sales	4,520	15.2%	3,922	40.1%	14,643	10.7%	13,231	45.7%
Other sales(1)	571	6.3%	537	4.3%	1,889	5.3%	1,794	6.2%
Total sales	\$ 21,807	5.9%	\$ 20,594	10.3%	\$ 72,598	5.3%	\$ 68,969	10.9%

(1) Other sales primarily relate to sales by convenience stores, excluding fuel; jewelry stores; manufacturing plants to outside customers; variable interest entities; and in-store health clinics.

(2) This column represents the percentage increase in the third quarter of 2011, compared to the third quarter of 2010.

(3) This column represents the percentage increase in the first three quarters of 2011, compared to the first three quarters of 2010.

The increase in total sales for the third quarter of 2012, compared to the third quarter of 2011, was primarily the result of our identical supermarket sales increase, excluding fuel, of 3.2% and an increase in fuel sales of 15.2%. The increase in total supermarket sales without fuel for the third quarter of 2012, compared to the third quarter of 2011, was primarily the result of our identical supermarket sales increase, excluding fuel of 3.2%. Total fuel sales increased in the third quarter of 2012, compared to the same period of 2011, due to an increase in fuel gallons sold of 8.3% and an increase in the average retail fuel price of 6.4%. The increase in the average retail fuel price was caused by an increase in the product cost of fuel. Identical supermarket sales, excluding fuel, increased primarily due to increased transaction count, an increase in the number of households shopping with us, an increase in the total units each household purchased and product cost inflation.

The increase in total sales for the first three quarters of 2012, compared to the same period of 2011, was primarily the result of our identical supermarket sales increase, excluding fuel, of 3.7% and an increase in fuel sales of 10.7%. The increase in total supermarket sales without fuel for the first three quarters of 2012, compared to the same period of 2011, was primarily the result of our identical supermarket sales increase, excluding fuel of 3.7%. Total fuel sales increased in the first three quarters of 2012, compared to the same period of 2011, primarily due to a 8.2% increase in fuel gallons sold and an increase in the average retail fuel price of 2.3%. Identical supermarket sales, excluding fuel, increased primarily due to increased transaction count, an increase in the average sale per shopping trip, an increase in the number of households shopping with us and product cost inflation.

We define a supermarket as identical when it has been in operation without expansion or relocation for five full quarters. Fuel discounts received at our fuel centers and earned based on in-store purchases are included in all of the supermarket identical sales results calculations illustrated below and reduce our identical supermarket sales results. Differences between total supermarket sales and identical supermarket sales primarily relate to changes in supermarket square footage. Identical supermarket sales include sales from all departments at identical Fred Meyer multi-department stores. Our identical supermarket sales results are summarized in the table below. We used the identical supermarket dollar figures presented below to calculate percentage changes for the third quarter and the first three quarters of 2012.

Identical Supermarket Sales

(\$ in millions)

	November 3, 2012	Percentage Increase	Third Quarter November 5, 2011	Percentage Increase(1)
Including fuel centers	\$ 19,457	5.2%	\$ 18,497	9.4%
Excluding fuel centers	\$ 16,057	3.2%	\$ 15,555	5.0%

(1) This column represents the percentage increase in identical supermarket sales in the third quarter of 2011, compared to the third quarter of 2010.

Identical Supermarket Sales

(\$ in millions)

Three Quarters Ended

Edgar Filing: KROGER CO - Form 10-Q

	November 3, 2012	Percentage Increase	November 5, 2011	Percentage Increase(1)
Including fuel centers	\$ 65,001	4.8%	\$ 62,002	9.9%
Excluding fuel centers	\$ 53,978	3.7%	\$ 52,039	4.9%

(1) This column represents the percentage increase in identical supermarket sales in the first three quarters of 2011, compared to the first three quarters of 2010.

Gross Margin and FIFO Gross Margin

Our gross margin rate was 20.29% for the third quarter of 2012, as compared to 20.57% for the third quarter of 2011. Our gross margin rate was 20.44% for the first three quarters of 2012, as compared to 20.92% for the first three quarters of 2011. The decrease in the third quarter of 2012, compared to the third quarter of 2011, resulted primarily from increased fuel sales, continued investments in lower prices for our customers and increased shrink and warehouse and transportation costs, offset slightly by a decrease in the LIFO charge and advertising costs as a percentage of sales. The decrease in the first three quarters of 2012, compared to the first three quarters of 2011, resulted primarily from increased fuel sales, continued investments in lower prices for our customers and increased shrink costs, offset slightly by a decrease in the LIFO charge as a percentage of sales. Retail fuel sales lower our gross margin rate due to the very low gross margin on retail fuel sales as compared to non-fuel sales.

We calculate First-In, First-Out (FIFO) gross margin as sales minus merchandise costs, including advertising, warehousing, and transportation expenses, but excluding the LIFO charge. Merchandise costs exclude depreciation and rent expenses. Our LIFO charge was \$15 million for the third quarter of 2012 and \$62 million for the third quarter of 2011. Our LIFO charge was \$96 million for the first three quarters of 2012 and \$142 million for the first three quarters of 2011. FIFO gross margin is a non-GAAP financial measure and should not be considered as an alternative to gross margin or any other GAAP measure of performance. FIFO gross margin should not be reviewed in isolation or considered as a substitute for our financial results as reported in accordance with GAAP. FIFO gross margin is an important measure used by management to evaluate merchandising and operational effectiveness. Management believes FIFO gross margin is a useful metric to investors and analysts because it measures our day-to-day merchandising and operational effectiveness.

Our FIFO gross margin rate was 20.35% for the third quarter of 2012, as compared to 20.87% for the third quarter of 2011. Retail fuel sales lower our FIFO gross margin rate due to the very low FIFO gross margin on retail fuel sales as compared to non-fuel sales. Excluding the effect of retail fuel operations, our third quarter 2012 FIFO gross margin rate decreased 25 basis points, as a percentage of sales, compared to the third quarter of 2011. This decrease in the third quarter of 2012, compared to the third quarter of 2011, resulted primarily from continued investments in lower prices for our customers and increased shrink and warehouse and transportation costs as a percentage of sales.

Our FIFO gross margin rate was 20.58% for the first three quarters of 2012, as compared to 21.13% for the first three quarters of 2011. Excluding the effect of retail fuel operations, as a percentage of sales, our FIFO gross margin rate decreased 42 basis points for the first three quarters of 2012, compared to the first three quarters of 2011. This decrease in the first three quarters of 2012, compared to the first three quarters of 2011, resulted primarily from continued investments in lower prices for our customers and increased shrink and warehouse costs as a percentage of sales.

LIFO Charge

The LIFO charge was \$15 million in the third quarter of 2012 and \$62 million in the third quarter of 2011. The LIFO charge decreased in the third quarter of 2012, compared to the third quarter of 2011, primarily due to lowering our expected annualized product cost inflation for 2012 compared to 2011 in the third quarter of 2012.

The LIFO charge was \$96 million in the first three quarters of 2012 and \$142 million in the first three quarters of 2011. The LIFO charge decreased in the first three quarters of 2012, compared to the same periods in 2011, primarily due to our expected decrease in annualized product cost inflation for 2012 compared to 2011.

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, utilities, and credit card fees. Rent expense, depreciation and amortization expense, and interest expense are not included in OG&A.