

FINAL TRANSCRIPT

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KFT - Q3 2006 Kraft Foods Earnings Conference Call

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PRESENTATION

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Operator

Good afternoon. Welcome to the Kraft Foods' third quarter 2006 earnings conference call. Today's call is scheduled to last about one hour, including remarks by Kraft Foods management and the question and answer session. [OPERATOR INSTRUCTIONS]

I will now turn the call over to Mr. Chris Jakubik, Vice President of Investor Relations for Kraft. Please go ahead, sir.

Chris Jakubik - *Kraft Foods - VP, IR*

Thank you. Good evening. Thanks for joining us on our conference call. I am Chris Jakubik, Vice President of Investor Relations. With me are Irene Rosenfeld, our Chief Executive Officer, and Jim Dollive, our Chief Financial Officer.

As you know, during this call we may make forward-looking statements about the Company's performance. These statements are based on how we see things today, so they contain an element of uncertainty. Actual results may differ materially due to risks and uncertainties. Please refer to the cautionary statements and risk factors contained in the Company's 10-K and 10-Q filings, for a more detailed explanation of the inherent limitations in such forward-looking statements.

We will start today's call with a perspective from Irene. Jim will then provide an overview of our third quarter performance, and our updated earnings guidance, and Irene will then wrap up, so I will turn it over to Irene.

Irene Rosenfeld - *Kraft Foods - CEO*

Thanks, Chris. Good evening.

I would like to begin with my perspective on the quarter, and following Jim's remarks, share some observations about the business, as I begin my second 100 days on the job. I remain excited and optimistic about Kraft's potential. The Company has many strengths that we are working to unleash. We have begun an intense review of growth areas, and we are working on a plan that I will share with you in February, that will highlight a set of tangible growth opportunities.

I remain optimistic about Kraft's ability to grow faster, by becoming more aligned with consumption patterns, and products that provide consumers with convenience, meaningful variety, health and wellness, and greater access. Regarding the third quarter, I have characterized it as mixed, because it is a dichotomy of ups and downs.

On the positive side, our restructuring efforts are generating significant savings. We're reinvesting those savings in advertising and new product initiatives, and where we have made investments, we are seeing some good results. For example, our convenient offerings, such as powdered beverage sticks, and our portfolio of Convenient Meals, are all showing strong growth. In addition, consumer demand for better-for-you options is driving the growth of our 100-calorie packs, Sensible Solutions, and South Beach diet products.

That gives me confidence that our brands will respond to the right programs, and that ongoing investment in our growth opportunities will pay off. In addition, our eastern Europe, Middle East and Africa, and Latin American regions continue to show good momentum and solid growth, and we are encouraged by the early integration activities of the United Biscuits Iberia business.

Offsetting these positives though are some parts of the business that are clearly not performing at the level we need them to. For example, in North America, categories like ready-to-drink beverages and pourable salad dressings have significant challenges. Internationally, we continue to face issues in the EU. And Tassimo while growing is not yet meeting our expectations. These downward pressures have prevented our top line from growing faster. So addressing these issues must and will be a key part of our strategic plan.

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Before I talk more about what we are doing to develop that plan, let me turn it over to Jim, who will take you through the details of the quarter.

Jim Dollive - Kraft Foods - CFO

Thanks, Irene, and hello, everyone. Before I begin, please keep in mind that unless otherwise noted, my comments will exclude the items affecting comparability that were highlighted in our press release.

Now let us get into the numbers. Starting with sales, on a reported basis net revenues in the third quarter were up 2.3%, the negative impact of the divestitures was essentially offset by favorable currency, leading to organic net revenue growth of 2.2%. Product mix was again the largest contributor to our revenue growth adding 3.6 percentage points. Key contributors to our mix gains were strong double-digit growth in powdered beverages, the benefit of our continued pruning of low margin product lines, and lower ready-to-drink beverage volumes.

Volume for the quarter was down 1.9 percentage points. We had solid volume gains in Oscar Mayer, pizza, cheese, cereal and biscuits. However, these were more than offset by the product pruning, as well as weaknesses in ready-to-drink beverages, salad dressings, and ready-to-eat desserts. Pricing also contributed to our organic revenue growth adding 0.5 a percentage point as increases across several businesses were partially offset by lower prices on cheese and increased promotional spending in German coffee.

Moving to operating income, excluding the items that is affected comparability, it grew 5.6% versus prior year, generating a 40 basis point increase in margin. Here is where the improved income growth came from. Lower dairy costs net of pricing, improved volume remix in several categories, most notably in North American Beverages, biscuits, and cheese, and developing markets, restructuring savings and manufacturing productivity.

These positives were partially offset by a double-digit increase in advertising, to support new product programs like Crystal Light and Kool-Aid powdered beverage stick packs, and spending to expand our presence in developing markets. In aggregate, commodity costs were neutral as lower dairy costs offset higher packaging and energy.

Moving to the bottom line, our fully diluted earnings per share rose 9.5% versus last year to \$0.46, benefiting from the operating income growth in our share repurchase program. Lower interest expense and a lower effective tax rate were also positive contributors.

Moving on to the business segments, we will start with North American Beverages, where organic net revenues grew 1.4%. As I mentioned earlier, strong double-digit growth in powdered beverages was driven by our Crystal Light and Kool-Aid Single serve stick packs. Year-to-date these single-serve powdered beverages have generated more than \$100 million in revenue. In fact, the single-serve format has accounted for all of the growth in the powdered beverage category this year.

But growth in powdered beverages was partially offset by a 9% decline in ready-to-drink products. While the impact of product pruning in Canada was part of the volume decline, the more significant factor in the third quarter was lower volume in both aseptic and bottled beverages, primarily due to category declines.

Beverage revenues also benefited from the expansion of Tassimo hot beverage system. However, these revenues lagged our expectations, as machine sales are building more slowly than we envisioned. Looking forward to the fourth quarter, our Tassimo expansion will continue to pressure the OCI margin for beverages, as we expand availability and promote units at retail.

Turning to North American Cheese & Foodservice, organic net revenue was down 1.8%, due to the pruning of lower margin product lines in the Foodservice business, and price declines in cheese related to lower dairy costs. Beyond these factors our cheese business delivered very solid results. Product mix was up, cheese volumes were higher, and we gained share in five out

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of seven cheese categories in Q3, and six out of seven year-to-date. Given our share gains we are comfortable with our price gaps in cheese.

Moving on to North American Convenient Meals, organic net revenue was up almost 5%. The two key drivers were Oscar Mayer, where Deli Shaved Meats are growing strong double-digit and continue to drive market share gains in cold cuts, and pizza, where our new varieties of DiGiorno and California Pizza Kitchen, continue to perform well. Overall, this segment has been one of our strongest and most consistent performers since the initial brand investments two years ago.

Next is North American Grocery. On a reported basis, groceries net revenue in Q3 was down 7.6%, primarily due to the divestiture of the former Nabisco grocery business in Canada. Organic net revenue which excludes divestitures, acquisitions, and currency was down 1.5% in the third quarter. Our better-for-you offerings, such as ready-to-eat sugar-free Jell-O pudding, and sugar-free Cool Whip made solid gains.

However, market share declines in spoonables, as well as category and share weakness in salad dressings and overall ready-to-eat desserts, led to a volume decline of 4%. As we look at Q4, we expect a decline in bagged salad consumption to continue to affect the salad dressing category, and to dampen top line growth prospects for Grocery.

Moving to North American Snacks & Cereals. Organic net revenue grew 4.2% with solid growth in cookies, crackers, and cereals. Strong growth in base Oreo, Nilla wafers, and Newtons drove the upside in cookies. Cracker gains were lead by growth in two areas. First, base Wheat Thins and the success of Wheat Thins toasted chips have driven double-digit consumption growth in six of the last seven quarters. Second, the continued growth of 100-calorie-pack crackers. Despite these gains, our overall share of crackers has declined this year mostly due to Cheese Nips and Ritz.

Within cereals, our adult products are doing well, led by Honey Bunches of Oats and Grape-Nuts Trail Mix. These gains were partially offset by declines in kids cereals. This business has not been performing well, but we have recently seen some improvement, since we began advertising our Sensible Solution alternatives. Looking forward, our recent divestiture of our pet snacks brands and assets will be a drag on reported results for this segment.

Next is the EU where results were mixed. Organic revenue fell 1.1%. Product mix was favorable from growth in premium offerings, like Tassimo coffee and in Philadelphia cream cheese. However, pricing was down as we increased promotional spending in coffee, primarily in Germany. And volume declines in our grocery and cheese businesses, offset volume growth in both Beverages and chocolate.

As we reported separately, we completed the acquisition of the United Biscuits business in Spain and Portugal in September. Due to the timing of our acquisition, our third quarter results had no contribution from these operations. So far as I already mentioned, the integration is going well, and we remain enthusiastic about the opportunities this business presents.

Finally, developing markets Oceania and North Asia had another quarter of strong performance. Organic revenue growth was 9.4% driven by strong mix and pricing gains. Eastern Europe and Latin America were again the strongest areas of growth, with significant contributions coming from coffee in Russia and Ukraine, as well as strong category growth in chocolate, biscuits, and cheese in Latin America.

I will now take a minute to it cover our current year guidance issued today. Our guidance for organic net revenue remains unchanged at 3% or more on a comparable 52-week basis. Also we increased our GAAP earnings per share guidance by \$0.06, and tightened the range to the upper end of our guidance, going from a range of \$1.78 to \$1.83, to a new range of \$1.86 to \$1.89.

The increase is driven by two factors. First, is the anticipated \$0.10 gain related to the divestiture of the Minute Rice brand and related assets. The other factor is a \$0.04 reduction versus prior guidance, related to the gain on redemption of our interest in

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United Biscuits. Versus the original forecast, the actual gain impacted EPS by \$0.09 versus our prior estimate of \$0.13, due to changes in deferred taxes, as well as currency.

As for expectations on our earnings from operations, there are two factors to note. First, we now expect our 2006 effective tax rate to come in at 32.5% versus our previous expectations of 33%. However, this benefit is expected to be offset by our forecast of cumulative restructuring savings in 2006 of \$530 million, versus our prior estimate of \$560 million. This change is due to the timing of activities as we implement the various programs. For our total \$3.7 billion restructuring program, we continue to expect benefits over the life of the program, to match our original expectations of over \$1.1 billion.

Finally, one other reminder. Our fourth quarter this year will be a normal 13 weeks versus last year's 14 weeks. So that is the third quarter of 2006. It was the quarter with a number of encouraging positives, but also a few areas that need improvement.

Now I will turn it back to Irene.

Irene Rosenfeld - Kraft Foods - CEO

Thanks, Jim. Our third quarter results make clear that while we made progress, and our fundamentals have improved in recent quarters, we still have more work to do. When we spoke back in July, I said I would spend my first 100 days listening and learning, and that is exactly what I have done. I have been to every major region and met with employees from all levels of the Company. I have received thousands of employee suggestions and ideas. The response has been overwhelming and exceptionally helpful.

I have also spent time with consumers in their homes, learning how they eat and live. I have logged many miles in retail outlets from the U.S. to China to Russia to Brazil. From big box formats to wet markets.

Despite the tremendous differences among countries and cultures, I found that we already have in place two key ingredients in our recipe for growth. First, Kraft employees are capable, passionate and committed to the Company's success. They have responded enthusiastically to my message, let's get growing. Second, consumers love our brands and are looking for our help. But not all of my findings were quite so positive.

I also learned there are a number of things we need to fix. I have already mentioned a few of the business issues, but I also got clear feedback in three other areas. First, too many decisions were being made centrally in Chicago, far from the marketplace. One of our employees said it best in a note to me, and I quote, globalization should not imply centralization. Second, I heard that our goals by function were not always well-aligned with our business unit objectives, and third, many people felt our innovation pipeline is not robust enough, and I agree.

The organizational changes I announced last month are a first step toward addressing these issues. I began at the top by revamping my executive team, to help us become more agile, more creative, and more focused. This new team will enable us to use our global scale to its best advantage.

It will bring to bear the vast resources of Kraft, our brands, our technologies, and marketing know-how for the benefit of local consumers. We are also moving most day-to-day operational decision making back to our local markets and sectors, so that the key decision makers are closer to our consumers and our customers. And we are realigning our global functions to better support the goals and priorities of our businesses.

I need to underscore, however, these changes are a beginning, not an end. We have begun the process of developing our strategic plan by launching a number of strategic review teams, teams that are focused on developing game plans for our problem areas, and accelerating growth plans for our opportunity areas. The output I have seen is promising, and I look forward to sharing more with you early next year.

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In sum, I believe that Kraft today is in much better shape that it was just two years ago. We are beginning to position ourselves for a more exciting future, for our consumers, our customers, our employees, and for our investors. We have made some tough decisions to narrow price gaps and to lower costs. Where we have invested, we are beginning to see the benefits, but we have much more work to do.

Where we have good momentum, we need to accelerate it. Where we have issues, we need to fix them in order to generate growth more broadly across the business. Without a doubt, we need to develop an innovation pipeline that is broader, deeper, and more incremental. What I learned during my travels supports the view, that consumers around the world want quality food and ideas to feed their families.

I am confident that Kraft's broad product line can be marshalled to provide better solutions to meet those needs, while providing our retail partners with unique and powerful merchandising tools. As we speak, the strategic review teams I mentioned are hard at work. Let me be clear there is no silver bullet that will solve all of our issues overnight. The size and complexity of our business makes a single quick fix impossible.

So while I am confident that we will have a game plan in February that is cohesive, compelling, and consumer focused, it will take time to implement, and to realize our full potential. Developing this plan is the essential next step to getting Kraft growing faster, and that will be our focus over the next 100 days.

We would now be happy to take your questions.

QUESTIONS AND ANSWERS

Operator

[OPERATOR INSTRUCTIONS] Our first question is from Alexia Howard from Sanford Bernstein. Please go ahead.

Alexia Howard - Sanford Bernstein - Analyst

Hello there. Quick question on the product discontinuations that have been cited as drivers of volume decline in a number of areas. It seems as though the last few quarters organic sales growth has been fairly solid. A few questions around that.

Firstly, have these product discontinuations stepped up this quarter? Can you in any way quantify what impacts the product discontinuations have had on sales and volume growth this quarter, and how much more do you think there is to go on that front? I can understand why you would want to rationalize the portfolio, get rid of some of the dead wood, but how much further do you think you need to go with that?

Irene Rosenfeld - Kraft Foods - CEO

As Jim mentioned, our volume performance is actually a combination of product pruning, as well as category performance. We continue to take some aggressive pruning actions in some of our low margin product lines, particularly Foodservice. The decline though, in category performance, was largely ready-to-drink as we said. Pruning will continue to be an ongoing process for us. But I really expect that the heavy lifting will be over by the end of 2007.

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Alexia Howard - Sanford Bernstein - Analyst

Great. One other short question on media spending. Given that media spending has been up fairly substantially over the last couple of years, do you think that will continue to be something that you will need to step up through the course of 2007 substantially from where it is today? There has obviously been a step up double-digits is quarter?

Irene Rosenfeld - Kraft Foods - CEO

Obviously I am thinking a lot about that as we develop our strategic plan. But I expect that given the payoff that we have been seeing from some of our investments, we will continue to view that as a tool to help us to accelerate our growth.

Alexia Howard - Sanford Bernstein - Analyst

Okay. Thank you very much.

Operator

Your next question comes from Eric Katzman from Deutsche Bank. Please go ahead.

Eric Katzman - Deutsche Bank - Analyst

Good evening, everybody.

Jim Dollive - Kraft Foods - CFO

Hi, Eric.

Eric Katzman - Deutsche Bank - Analyst

I guess my first question has to do with as you kind of go in, there has been a lot more inflation pressure in the industry, and I guess how do you think about that, in terms of your targets for the Company? It seems like a difficult time for management to decide whether inflation is just kind of temporarily kind of slowing down, or if it is kind of set to renew itself again? How are you kind of thinking about that, and I guess also how is, how does the local managers decisions kind of play into that, because it seems like years ago when we had volatility in cheese, that's kind of what got the Company into trouble.

Irene Rosenfeld - Kraft Foods - CEO

Eric, I think we are all feeling that inflation and input costs will continue to be a challenge for us going forward. I am delighted actually that we have begun the process of our restructuring activities, to allow us to be able to maintain our overall position.

I feel very good about the progress we have made in managing our price gaps. We will continue to look to price to recover costs to address these ongoing issues, but net/net I think we are well-staged to be able to address the ongoing costs that will hit us on the input line.

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Eric Katzman - Deutsche Bank - Analyst

Okay. And, Jim, just so I am clear, I know this is kind of more shorter term, and obviously Irene is going to take the Company wherever she is going to take it, but just for this year, it seems like on an operating basis, you are at \$1.88 to \$1.93, and now excluding the gains and the charges, you are at \$1.90 to \$1.93, and the increase in the low end, is that tied basically to \$0.01 to \$0.02 from the tax rate, and that is really the only difference?

Jim Dollive - Kraft Foods - CFO

Not really. As I have said in the call, the tax rate pretty much offsets some of the restructuring savings, and the timing of those events. What we are really saying when you cut through it is given where we are year-to-date, this is the appropriate range for us to narrow with only a quarter left to go in the year.

Eric Katzman - Deutsche Bank - Analyst

Okay. So it shouldn't take, so basically you are saying the lower end, you raised the lower end with the tax rate being offset by the timing of the savings.

Jim Dollive - Kraft Foods - CFO

Exactly.

Eric Katzman - Deutsche Bank - Analyst

So in essence you are feeling a little bit better about things as we kind of end the year.

Jim Dollive - Kraft Foods - CFO

We are on-track with where we said we would be, and all we have done is narrow our guidance to the upper end of the range.

Eric Katzman - Deutsche Bank - Analyst

Okay. Thank you.

Operator

Your next question is from Chris Growe from AG Edwards. Please go ahead.

Chris Growe - A.G. Edwards & Sons - Analyst

Hi. Good evening.

Jim Dollive - Kraft Foods - CFO

Hi, Chris.

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Chris Growe - A.G. Edwards & Sons - Analyst

Just two questions. Thanks. First off, as you see the commodity costs inflation today and in some cases ticking up a little bit of course, in grains and elsewhere, do you regard Kraft as having a pricing ability, and I guess this really stems from my, another question on where you believe the price gaps are I think today in cheese. You made a comment about them looking okay today. Can you make a broad statement about pricing in general today?

Jim Dollive - Kraft Foods - CFO

Well, as Irene mentioned, we are better off in terms of our ability to recover these costs through pricing actions, in terms of our ability to recover these costs through pricing actions, so I am feeling pretty good about that.

The grain issue, the increase we are seeing now is primarily in wheat, but that will obviously have a spillover effect into other grains as well, that will not be a factor for us for the balance of the year, given the coverage we have on our commodities.

As far as the price gaps go on cheese, we continue to gain share in our cheese category, so on that basis, we are comfortable with where our price gaps are in cheese right now, even though cheese costs were lower beginning in the middle of the year, and they have come up a little bit, they are still below the overall cost of cheese is still below where it was a year ago at this time.

Chris Growe - A.G. Edwards & Sons - Analyst

Okay. Would you expect the same sort of cost environment in terms of the cost of goods sold being about flat in terms of incremental costs in the fourth quarter, much like we had here in the third given your hedging?

Jim Dollive - Kraft Foods - CFO

I really wouldn't want to get into a hard specific estimate on that, but we don't have a lot of risk to commodities for the balance of the year. Right now we are comfortable with the guidance that we have given for the balance of the year.

Chris Growe - A.G. Edwards & Sons - Analyst

Sure. That's helpful. Just the last question, pertains to volume, and it sounds like with this ongoing SKU pruning, and some incremental weakness in certain categories, there is a little bit of risk still to fourth quarter volumes, I shouldn't maybe say risk, but a little bit of incremental weakness as well, relative to what we expected before this. Is that a fair statement?

Jim Dollive - Kraft Foods - CFO

We have kept our guidance on the year pretty much the same, in terms of 3% or more on revenue. As far as the volume piece goes, we have seen the ready-to-drink business trail off a bit here lately, and that will probably carry over into the fourth quarter to some degree.

Chris Growe - A.G. Edwards & Sons - Analyst

Okay. Thank you.

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Operator

Thank you. Your next question comes from David Adelman from Morgan Stanley.

David Adelman - *Morgan Stanley Dean Witter - Analyst*

Good evening, and Irene thanks for doing the call. First, if you step back, over the last several quarters, Kraft's results might not have been great, but almost to the T, you had seen sequential improvement in the top line, and that clearly did not persist into this quarter, and I am just curious, broadly what do you think has changed? Why didn't that persist?

Irene Rosenfeld - *Kraft Foods - CEO*

Good evening David. Some of it we expected from commodity swings that we were aware of. The rest of it is about some of the problem areas that we referenced there, but at the end of the day, there is a lot of good news in this quarter, that I feel quite good about, that I really think bodes well for our actions and our plan going forward.

David Adelman - *Morgan Stanley Dean Witter - Analyst*

Why was the ready-to-drink category so weak? I know it hasn't been growing of late, but down 9% is obviously a significant decline.

Irene Rosenfeld - *Kraft Foods - CEO*

Well, I think without a doubt we start with the fact our powdered beverages are on fire, and I feel terrific about that, because as you know, that's a very important category for us. We have a leadership share, and it is highly profitable. The issue has been ready-to-drink, and there is a lot of competitive activity in that segment as you well know, and we simply haven't kept pace, so our goal going forward is to really determine what we want to do to compete more effectively in that segment.

David Adelman - *Morgan Stanley Dean Witter - Analyst*

Okay. And then lastly, Irene, do these results lead you to believe that the Company is marketing spending and aggregates at appropriate levels, and then linked to that, is the current base of profitability really a sustainable base of profit going forward that you can grow off of?

Irene Rosenfeld - *Kraft Foods - CEO*

I am thinking a lot about that as we put together our strategic plan, and I look forward to sharing those plans with you early next year.

David Adelman - *Morgan Stanley Dean Witter - Analyst*

Okay. Thank you.

Operator

Your next question comes from Mr. John McMillin from Prudential Equity Group. Please go ahead.

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John McMillin - Prudential Equity Group - Analyst

Hi, Irene, Jim and Chris.

Irene Rosenfeld - Kraft Foods - CEO

Hi, John.

John McMillin - Prudential Equity Group - Analyst

Just to see that 2% volume decline, or 1.9 just to continue David's discussion, Irene, you were part of a team, you know, that took the Company public when the hope was 5, is just part of your mindset, as you look forward, and I know even with David's question you didn't want to get into it, but is it just the Company has already changed a little bit to a volume to value story. Are we wrong just looking at that 2% volume decline, and just kind of being very concerned about it?

Irene Rosenfeld - Kraft Foods - CEO

You know, I say again, it is really too early for us to talk about what our plans are going forward. I will tell you that there is no question that we expect our volume as we get some of these less profitable items out of the portfolio, we expect our volume growth to get back on trend. We are not comfortable with where our volume rests today.

I have been very pleased to do see some progress on revenue, and in terms of our overall performance on mix. But part of our plan going forward really will be to get our volume growth back on track where we need it to.

John McMillin - Prudential Equity Group - Analyst

Just in Europe, I mean Nestle got out of U.K. confections, because it just didn't make sense. It seems to me the game you are playing in Germany with coffee, is if you get your prices below private label or at private label you grow, and if it just, does it make sense to play that price game in German coffee?

Irene Rosenfeld - Kraft Foods - CEO

Well, John, as you know, the EU, and Germany in particular, is a challenging market for everybody. I am actually feeling pretty good that we have taken some actions, specifically in Germany in this last quarter, to try to compete more effectively.

Longer term as we think about that geography, I am quite encouraged about the opportunity for UB to give us another leg of the stool, and that can then supplement our chocolate and our coffee business there. That is a key piece of what we're looking at as part of the strategic reviews.

John McMillin - Prudential Equity Group - Analyst

Other food executives have come into CEOs and they have wanted 100 days, and then another 100 days, but not many of them have had, whatever it was, decades of experience with the Company already.

Just in terms of kind of laying out the strategic plan, why did you pick February, you know, not that what's taking you so long, but does it really take you that long to kind of put it all together, given your past tenure with the Company?

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Irene Rosenfeld - Kraft Foods - CEO

I certainly have a pretty good handle on where many of the problems are. Our issue is really, see some of these have been fairly longstanding problems, and I don't really want to pretend, John, to have a quick off-the-cuff answer, so these teams that we have put in place to really help us to do a deep dive in a number of our core categories, to find where the areas of the portfolio and geographies are that have the greatest leverage, and where we really believe we can get the best return on our investment on our investment is time well spent. I believe we are taking the time necessary to be able to come back to you with a quality plan.

John McMillin - Prudential Equity Group - Analyst

Just in terms of the pipeline of new products, it has taken Campbell's, three years to get out things like low sodium soup and so forth, to the extent you have walked back in the Company, what is your impression of the product pipeline that we will look at in '07, and even in to '08?

Irene Rosenfeld - Kraft Foods - CEO

Well, you know, I think we have had a number of good successes. I cited a number of those we feel very good about our progress in our powdered stick packs, and our deli shaved performance, and pizza performance, and a number of our better-for-you offerings.

Quite frankly, it is a fairly short list, and I don't see enough ideas behind it, and in answer to an earlier question, part of why it is going to take a while to come back to you with a plan is because that's a very important piece of our strategic plan going forward, and so at the end of the day, our focus is going to be on developing bigger ideas that truly meet consumer needs in the areas that I mentioned a moment ago.

John McMillin - Prudential Equity Group - Analyst

Great. Thanks for everything.

Irene Rosenfeld - Kraft Foods - CEO

You are welcome.

Operator

Thank you. Your next question is coming from Pablo Zuanic from J.P. Morgan. Please go ahead.

Pablo Zuanic - JPMorgan Chase & Co. - Analyst

Hello, everyone. Irene, help me understand this, from outside I have always throughout the problem areas were going to be those where you had low market share, and where private label had big market share. I am surprised to see that to a good extent, the cheese division and Oscar Mayer have been pretty much normalized, or fixed, if I can use that word, whereas the areas where you have higher market share and more branded type of competition are the ones that are lagging, so the question really is, from outside should I be more worried about the private label competition, or the issue has been more about the branded competition that you have, because at the end of the day the organizational impediments that you have talked about affect all divisions alike. So help me understand that.

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Irene Rosenfeld - *Kraft Foods - CEO*

Pablo, I think our major focus is making sure that our offerings and our marketing plans are designed to meet the needs of our consumers, and category to category the competition varies, but at the end of the day, the areas where we are having the greatest success, and I would cite Convenient Meals as probably our most shining example, are those areas where we really have products with a point of difference, like Deli shaved cold cuts, like the CPK thin pizzas, like DIGIORNO whole wheat pizzas, and those are the kinds of areas that I really believe if we can continue to bring some of that consumer focus more broadly to the portfolio, we can make a lot of headway. It is no accident that I asked Rick Searer, who ran those businesses, to take over all of North America, and I am really looking forward to the output of Rick and his team, as we put the strategic plan together.

Pablo Zuanic - *JPMorgan Chase & Co. - Analyst*

Along those lines, are the divisional labels, where we realized is that there was probably more turnover to the CEO label over the last five years, in terms of the divisional heads, and intensive products being moved across divisions, can you comment about the challenge of the divisional label? It seems that Rick Searer, that division benefited from having the same person in charge for the past 40 years pretty much. Can you talk about how that turnover at the divisional label both in moving products around and changing the divisional shades, might have affected the performance of those divisions?

Irene Rosenfeld - *Kraft Foods - CEO*

It is a good question, Pablo. It is hard to say. I think at the end of the day my focus has really been to revamp the executive team in a way that I think will allow them to move faster, to be more agile, and to really be able to better unleash the creativity of the organization, and I feel highly confident that the steps that we have taken will move us in that direction.

Pablo Zuanic - *JPMorgan Chase & Co. - Analyst*

Okay. One last one. Can you broadly define or conceptually explain how do you think about divestitures? From outside the concern is that large divestitures could be dilutive, they have been in other companies, or I know you are still going through to review your portfolio. Can you just comment, what are key definitions, what are you going to look at in terms of thinking about what would need to be divested?

Irene Rosenfeld - *Kraft Foods - CEO*

Obviously portfolio composition will be a key piece of our strategy, as it has been in the past. It is something we will always look at. It is not something I am prepared to comment on today.

Pablo Zuanic - *JPMorgan Chase & Co. - Analyst*

Okay. Just in terms of the SG&A expense, I know that in this quarter there was about 40 basis points. You say you haven't decided in terms of how to think about that for next year. So you are leaving the door open for some pretty significant increases in marketing, that could limit the earnings growth over the next two years. Taking a long term approach, I guess that is the right approach to take. I think you leave the door open for us to interpret it that way.

Irene Rosenfeld - *Kraft Foods - CEO*

At this point, Pablo, it is too early for us to give you specific guidance for 2007. We will be back to you early next year with the overall profile of our plan.

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Pablo Zuanic - JPMorgan Chase & Co. - Analyst

All right. Thank you.

Operator

Your next question comes from Andrew Lazar, Lehman Brothers. Please go ahead.

Andrew Lazar - Lehman Brothers - Analyst

Good evening. First on mix, it has obviously been a positive sort of driver of the top line and profitability over the last couple of quarters. It has been pretty broad-based it seems, but undeniably one of the biggest pieces of that has been the weakness I guess in ready-to-drink, and the strength in powder, which gives you obviously, a significant mix advantage there.

I am trying to get a sense, is net/net, is the weakness in ready-to-drink something that you are actually okay with, or is really more positive like, is it okay if that continues because you're getting positive mix, or if ready-to-drink starts to improve, you lose a big part of the mix advantage, do you just hope that volumes come back to more than offset that? To keep the top line going? I am trying to get a better sense of how to think about that.

Jim Dollive - Kraft Foods - CFO

I am not sure, Andrew, that I would pin all of that on mix. Obviously mix has been a conscious effort on our part to improve, and the things I would focus on are the areas we are putting our new product initiatives, and the pruning activities. The ready-to-drink business being down is mostly a category issue, and while that is positively contributing to the mix profile, I wouldn't necessarily encourage that.

Andrew Lazar - Lehman Brothers - Analyst

Okay. It has been broad based, as I mentioned, we have certainly seen mix in a lot of other segments as well. But obviously as that improves, you lose a little benefit on the top line, and therefore I guess something like volume has to make up the difference.

Jim Dollive - Kraft Foods - CFO

And then I wouldn't have the problems on volume that we're talking about.

Andrew Lazar - Lehman Brothers - Analyst

Yes, yes. Separately, I guess, one of the things that was obviously discussed a lot, you know, when Kraft came public and the years thereafter, where obviously advantages of scale that has been talked about, scale versus focus and all of that. Kraft certainly has scale in a lot of categories across a lot of aisles, and that has never seemed to really be an advantage that the Company has been able to sort of be able to show or take advantage of.

Irene, you spent a stint over the last two years at an organization which is not as broad, but certainly had some success in crossing aisles, whatever power of one type of thoughts, and as you think about things, I am just trying to get a general sense, is that scale across aisles something that you think actually has value? Is part of the plan going to be seeing some way to sort of bring that in a more tangible way to the retailer, the consumer, or is it really just about category by category, everybody cares about what they care about, and you just have to do everything right in each category?

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Irene Rosenfeld - Kraft Foods - CEO

Andrew, as I have said before, I am not prepared today to talk about the strategy, but I will tell you without a doubt that is going to be a cornerstone of our story. I really do believe that the breadth and depth of our portfolio, is and can be a source of competitive advantage, and that will play a key role in our strategy going forward.

Andrew Lazar - Lehman Brothers - Analyst

Do you think some of the organizational announcements will help that? In other words, is that an impediment perhaps, to the way Kraft was able to not use the scale to an advantage in the past, or is it something about the way Kraft has interacted with its retail partners in the past, versus how you might think about it going forward?

Irene Rosenfeld - Kraft Foods - CEO

Hard to say. I think it is a combination of people and incentives and structure, and I think as we move forward here, to the extent that this is going to be an important part of our strategy, we will address a number of those pieces.

Andrew Lazar - Lehman Brothers - Analyst

Thanks very much.

Operator

Your next question is coming from David Nelson from Credit Suisse. Please go ahead.

David Nelson - Credit Suisse - Analyst

Good afternoon. Question on the tax rate, Jim, you talked in the past about it possibly rising toward the statutory rate of 36%. Would that still be your thinking eventually?

Jim Dollive - Kraft Foods - CFO

Eventually, yes. Obviously we look what we can do to manage that down, but sooner or later we are going to end up at the 36% rate longer term.

David Nelson - Credit Suisse - Analyst

This quarter you lowered your expected benefits from restructuring. Last quarter you had lowered the restructuring spending from 1.3 to 1 billion. Are they related, or just timing, as you said?

Jim Dollive - Kraft Foods - CFO

They are all related to timing.

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David Nelson - Credit Suisse - Analyst

Okay.

Jim Dollive - Kraft Foods - CFO

I think the important message there, David, is from the overall total program we're still on track with that whole initiative.

David Nelson - Credit Suisse - Analyst

Okay. In March of this year, Kraft announced that they were outsourcing IT to EDS. Any early learnings on what might be achieved efficiency-wise from that?

Irene Rosenfeld - Kraft Foods - CEO

Too early to tell, David, but we are optimistic that it can really be a help to us.

Jim Dollive - Kraft Foods - CFO

And I would just add that that transition is going very well right now.

David Nelson - Credit Suisse - Analyst

Thank you.

Operator

Your next question is coming from David Palmer from UBS. Please go ahead.

David Palmer - UBS - Analyst

Hi, everyone. Irene, you noted the need to reinvest in developing an innovation pipeline. I was wondering if obviously your plan is coming in February, but have you been able to start this reinvestment process for the second half of this year?

Irene Rosenfeld - Kraft Foods - CEO

On many of our new products as you know, David, are out on the street. In fact, a lot of our new products for the first half of next year, we have begun to show to retailers. The real opportunity as we think about our investments will really be more towards the back half of next year. But the opportunity to revamp our advertising support and our marketing support for some of those items, is really what we are working on right now.

David Palmer - UBS - Analyst

Has this been a question of incremental spending, and has that incremental spending begun already?

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Irene Rosenfeld - Kraft Foods - CEO

You would not have seen any incremental spending in the plans so far, or in our third quarter performance. The opportunity, though, is really about the niche of the ideas. So a lot of our focus is really rethinking our product usage in the context of consumers total lives, and basically rethinking the frame of reference for some of the ideas that we are bringing to market.

The spending will be a piece going forward. It has not been a piece of our performance so far this year. Other than the overall investment that we have made, the higher investment that we have made in advertising.

David Palmer - UBS - Analyst

Great. Thanks. And with regard to Tassimo, you were frank talking about the fact that's been disappointing thus far in the machine sales. Could you perhaps elaborate as to is there any adjustment, in terms of the grand strategy with Tassimo, any sort of repositioning that you plan to do there?

Irene Rosenfeld - Kraft Foods - CEO

David, we continue to say Tassimo is a promising business. It is growing, but as I mentioned, it is not where we like it to be, on both the top or the bottom line. We continue to see very promising results in terms of on demand coffee penetration, especially in the EU, but it is a growing behavior that we are seeing in North America, and we are finding that consumers are very satisfied with our machine.

The key activity that we are going through right now, though, is to reexamine our business model to make sure that we have the appropriate pacing of our investment, against the size and the expansion of the opportunity, and that will be an important part of our strategic plan.

David Palmer - UBS - Analyst

One last one on the cookie and cereal volume lately. Actually bills just limited to really just cookies and crackers, and really what might be getting that going, is it really 100-calorie packs, or is it something more than that, perhaps you can give us details of what seems to be helping sales trends there?

Irene Rosenfeld - Kraft Foods - CEO

We feel very good about our trends. Our biscuit revenue was up over 4% this quarter, as you know. We cited a number of successes, aside from 100-calorie packs, and toasted chips, which continue to be drivers for us. Our Oreo trademark overall is doing well. Our Wheat Thins products, the entire product line is doing well.

And we have launched these new 'peel and seal' packages, which you may see out at retail, that enables the consumer so reclose the package after she takes the cookie out. We think there is a whole bunch of innovation that is going on in that sector, that we believe we will be able to continue to fuel our growth.

David Palmer - UBS - Analyst

Thanks very much.

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Operator

Next question is coming from David Driscoll from Citigroup Investment. Please go ahead.

David Driscoll - *Citigroup Investment - Analyst*

Hi, Irene, and thanks a lot for taking the call. You mentioned that the top line was weak, but the question I have for you, is are you just simply asking too much of the asset base? The Company really is heavily focused in North America. When you look at the composition of organic net revenue growth, North America grew 1.7 while your developed, excuse me, the developing markets grew at 9.4%. What gives you the confidence level that this thing really did really underperform in the quarter?

Irene Rosenfeld - *Kraft Foods - CEO*

I start, David, with the fact that we have some terrific growth in a number of our sectors within the North American business. And as I look at the drivers of that growth, as I mentioned earlier, a lot of it is about products that are better meeting consumer needs, and I think that's a formula that we can continue to leverage going forward. There is no question that our growth opportunities in developing markets will continue to be attractive, and we will make the necessary investments there.

David Driscoll - *Citigroup Investment - Analyst*

You do you look at the developing markets, and say to yourself, that this is really where Kraft needs to be positioned? Just earlier we saw Wrigley report earnings, and they reported their Asian business grew 23%, and of course, they planted the seed of that growth a long time ago. What it really feels to me like, is that's what Kraft needs to be doing, but it is just simply not happening anywhere near fast enough. Are you really prepared to take some bold actions and push the Company into those emerging markets?

Irene Rosenfeld - *Kraft Foods - CEO*

Obviously I am thinking a lot about that, as we think about our strategy going forward, David, but I will tell you the North American market is one of the most profitable food markets in the world, and we have a very strong position in a lot of core categories here, and I feel highly confident that there is opportunity for us to be able to get our growth rate up above the 2% rate that we saw this quarter, closer to the guidance that we have given.

David Driscoll - *Citigroup Investment - Analyst*

One final question on the management changes. Over the course of time here, we have seen a rather large exodus of top management talent in recent years to the Hershey team, the Mattel team, your recent changes. Do you have positions open in the Company that you are trying to fill from outsiders, or is your plan to take simply the people inside of Kraft, and bring them up in the ranks, and use them to drive your plan going forward?

Irene Rosenfeld - *Kraft Foods - CEO*

My goal, David, is to really be able to develop an A Team, regardless of where they came from, but I do expect it will be a combination of folks from both the inside and the outside.

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David Driscoll - Citigroup Investment - Analyst

I do appreciate it. Thank you.

Operator

Your next question is from Kenneth Zaslow from BMO Capital Markets. Please go ahead.

Kenneth Zaslow - BMO Capital Markets - Analyst

Good evening, everyone.

Irene Rosenfeld - Kraft Foods - CEO

Good evening.

Kenneth Zaslow - BMO Capital Markets - Analyst

One question you guys put on the call, was that you guys are comfortable with your price gaps relative in cheese. But if I look at history, and not to belabor this point, but it looks like it is starting to get back to the level of two or three years ago, when you guys had all sorts of your problems with the price gap. Why is it okay now, but it wasn't okay then?

Jim Dollive - Kraft Foods - CFO

I will answer that one, Ken. I have to look at it and say two things. One, we are seeing the share growth, but more importantly we are making the investments in the business itself, in terms of some of the new product initiatives, as well as the advertising programs. It is really those combinations of things, that help drive the brand value, to the degree that brand value does help bring up and change the whole price range, that's terrific, but right now we continue to gain share, and we feel good about where we are.

Kenneth Zaslow - BMO Capital Markets - Analyst

If next year or in '07, if the price of cheese goes up, the input costs go up, you think you are going to be able to keep this premium?

Jim Dollive - Kraft Foods - CFO

Well, I think the point is we will manage the price gaps. We're going to be diligent and make sure that those price gaps stay where they need to be, so that we don't see the kind of share declines that we had before.

Kenneth Zaslow - BMO Capital Markets - Analyst

Okay. Aside from coffee, have you taken any other pricing actions during the quarter that we should be aware of?

Jim Dollive - Kraft Foods - CFO

There was an announcement on cereal other than that, there was not much other activity.

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Kenneth Zaslow - *BMO Capital Markets - Analyst*

Great. Thank you.

Operator

Your next question is from Steven Kron from Goldman Sachs. Please go ahead.

Steven Kron - *Goldman Sachs - Analyst*

A couple of follow-ups if I can. I want to go back to building the brand value and go back to the marketing spend for a second, and clearly, Irene, your strategy to build a deep product pipeline to spend against makes a lot of sense, but I guess two questions on that.

If you had to segregate your business, and you look at the categories you compete in, where do you see right now perhaps some best opportunities, where perhaps your product pipeline is looking better, and you think you have the right marketing approach in the pipeline, and related to that, can you maybe talk about the mix of marketing spend going forward, if you think that might change, not necessarily the incrementality of the marketing spend, but potentially the mix, and then I have another follow-up after that.

Irene Rosenfeld - *Kraft Foods - CEO*

Steve, as I mentioned earlier, we are going through a fairly intensive review right now of our growth opportunities across the Company, and that is exactly the exercise that I look forward to sharing with you early next year, so I am not really going to talk today about specific categories.

What I will tell you is I am encouraged by some of the early work that we are seeing, and I will commit to you that when we are all done, we are going to have a very cohesive plan that is consumer focused.

Steven Kron - *Goldman Sachs - Analyst*

And the follow-up on Tassimo, I just want to make sure I understood correctly, the disappointment thus far in North America, is it more of an awareness issue, or are you finding through your market research or whatever, that cost is an inhibitor to the consumer at this point?

Irene Rosenfeld - *Kraft Foods - CEO*

The issue is actually on Tassimo. It is a much bigger business today in the EU than it is, we are just getting started in North America, so the issues were we are looking at have to do with the entire business model, and that is what we are spending our time looking at. That is something that I will share with you early next year as we look at it, but what we are encouraged about is that on-demand coffee is clearly here to stay. It is a growing behavior, and we are seeing consumers around the world really exhibiting that behavior.

Steven Kron - *Goldman Sachs - Analyst*

Okay. Thanks.

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Operator

Your next question is coming from Tim Ramey from D.A. Davidson. Please go ahead.

Tim Ramey - *D.A. Davidson & Co. - Analyst*

Irene, earlier in your comments, you said restructuring activities are generating savings, and you are reinvesting savings in product development. You have had this question posed six different ways. Isn't this sort of just a classic guns versus butter kind of question? Do we have enough guns? Can you give us sort of broad brush on that, without giving us earnings guidance for 2007?

Irene Rosenfeld - *Kraft Foods - CEO*

I guess what I will say is we are analyzing the stuff that's working. I would tell you that the common theme is that these are areas of opportunity that really meet consumers consumption patterns, so we are finding the things that are growing are providing consumers with convenience, with meaningful variety, with health and wellness offerings, and are easily available, and that will be a key theme of ours, as we look at the areas where we think we can have the greatest leverage going forward, so it is not necessarily a specific category, as much as it is ideas that have those characteristics that are well aligned with where consumers are.

Tim Ramey - *D.A. Davidson & Co. - Analyst*

Yes. I think the question, is this about returns to shareholders, or is it about growth, and I mean in your prepared comments clearly you say it is about growth. Is that not right?

Irene Rosenfeld - *Kraft Foods - CEO*

Actually it is about both. We believe that our ability to generate profitable growth will over time really continue to yield attractive returns to our shareholders.

Tim Ramey - *D.A. Davidson & Co. - Analyst*

Thank you.

Operator

Your next question comes from Edgar Roesch from Banc of America Securities. Please go ahead.

Edgar Roesch - *Banc of America Securities - Analyst*

Good evening.

Irene Rosenfeld - *Kraft Foods - CEO*

Good evening.

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Edgar Roesch - Banc of America Securities - Analyst

Curious about the trimming of SKUs during the quarter, and I think in the first half it had about a 200 basis point negative impact on volume. Could you quantify that for the third quarter for us?

Jim Dollive - Kraft Foods - CFO

This is the SKU pruning activities.

Edgar Roesch - Banc of America Securities - Analyst

Yes, exactly.

Jim Dollive - Kraft Foods - CFO

From a revenue perspective, it was about 2 points. There was a little bit more on the volume side because of the SKU towards the ready-to-drink business, but we typically think about that in terms of its revenue impact, and it continues to run at about 2 percentage points.

Edgar Roesch - Banc of America Securities - Analyst

Terrific. Thanks. Trying to understand the dynamic, I know in the second quarter your SG&A dollars were essentially flat year-over-year. It is included in additional funding of advertising, and that was being funded by restructuring savings, so the SG&A dollars were up in the third quarter. I was wondering if you could speak about how much of that was driven by the advertising--?

Jim Dollive - Kraft Foods - CFO

What you are looking at is what we call the marketing admin and research line. The key drivers in that change were the advertising increase. We also have currency impact affecting that as well. There is some restructuring costs caught up in the numbers you are looking at. The actual overhead costs were relatively flat on a year-to-year basis.

Edgar Roesch - Banc of America Securities - Analyst

Okay. Just trying to get an understanding of the dynamic, because I know next year you will have roughly another 70 basis points of cost savings freed up, that could be reinvested in advertising. Then the last question was on developing markets and Oceania, that division had some pretty tremendous mix improvement. Can you speak to some of the drivers there?

Jim Dollive - Kraft Foods - CFO

Well, certainly. On the mix side, as far as that goes, we had some good growth in some of the eastern European businesses, and a lot of that is driven by soluble coffee, which tends to be one of our better mix contribution items. We also saw some changes in the Asia Pacific component, and again we are getting into different businesses there, but the growth is really what drove a lot of the mix implications, particularly as we look at the eastern European part. The part in Latin America that contributed was there were some declines in the ready-to-drink business, particularly in Mexico.

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Edgar Roesch - *Banc of America Securities - Analyst*

Alright. Thanks very much.

Operator

Thank you. Your next question is from Eric Serotta from Merrill Lynch, please go ahead.

Eric Serotta - *Merrill Lynch - Analyst*

Good evening.

Irene Rosenfeld - *Kraft Foods - CEO*

Good evening.

Eric Serotta - *Merrill Lynch - Analyst*

I know that you spoke in some detail about your disappointment in the innovation progress thus far. I am wondering whether you could elaborate, Irene, on what you see as the key impediments to date in Kraft's innovation pipeline? Was it idea generation, was it being close enough to consumer, or was some other factor, or was it on the execution side, or some factors I haven't mentioned?

Irene Rosenfeld - *Kraft Foods - CEO*

You know, Eric, I think in some respects it is going to be a combination of factors, but I guess my overarching observation would be that we have too many of our innovations are what I would characterize as new to Kraft, but not new to the world, and I look at items like, for example, Good Seasons liquid salad dressings. We are quite proud of that, and it is a good item for us, but it is not something that really brought a new benefit to consumers.

As opposed to some of the ideas like our powdered beverage sticks which we launched initially, our 100-calorie packs, which have have been copied by many folks out there.

As we move forward, it is critically important we really start to look at some of the these adjacency opportunities, where we can sort calories without necessarily having to go directly after the specific opportunity, and I think that will allow us to develop more competitively advantaged ideas.

The second piece, though, is to look at the consumer behavior within the whole totality of her life. We have tended to look at a number of our categories very narrowly, and I think as you see us moving forward, we are going to look at these categories a lot more broadly, which will then give us some exciting new ideas, I hope.

Eric Serotta - *Merrill Lynch - Analyst*

Okay. Thank you very much.

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Operator

Your last question is coming from Todd Duvick from Banc of America. Please go ahead.

Todd Duvick - *Banc of America Securities - Analyst*

Good afternoon. Just a couple of quick questions from a fixed income stand point. First of all, you have got about \$2.6 billion of debt coming due over the next year, and I think 1.25 billion maturing next week. Can you tell us how we should think about this, in terms of refinancing versus paying down debt?

Jim Dollive - *Kraft Foods - CFO*

Well, the bond offering that becomes due next week, we will just cover that with our commercial papers, so we will essentially refinance that with short-term debt.

As far as the next twelve months go, we are actually more like \$3 billion in terms of debt that will be coming due, and we will be taking those as they come up to them. I am not going to get into an estimate right now of whether or not we are going to, whether or not and how we are going to refinance those.

Todd Duvick - *Banc of America Securities - Analyst*

And then just one final question, with respect to your strategic plan that you are looking to unveil, any thoughts in terms of post the spin-off from Altria, how that might affect your financial policy going forward, or could we at least look for some guidance perhaps in February?

Jim Dollive - *Kraft Foods - CFO*

It is a little bit early for us to be talking about that right now. I think we will deal with that one when the time is appropriate to deal with it.

Todd Duvick - *Banc of America Securities - Analyst*

Okay. Thank you very much.

Operator

Thank you. There are no further questions, and I would like to turn it the floor back to Mr. Chris Jakubik for his closing comments. Please go ahead, sir.

Chris Jakubik - *Kraft Foods - VP, IR*

Okay. Thank you very much. If anybody has any further questions of a non-material nature, I will be available to take your calls, and for those of the media who have any further questions, Perry Yeatman will be available to take calls as well. Thank you and good evening.

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Operator

Thank you. This concludes today's Kraft Foods third quarter 2006 earnings conference call. You may now disconnect your lines at this time, and have a great evening.

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