No. 17-537

In the Supreme Court of the United States

MERCURY CASUALTY COMPANY, ET AL.,
Petitioners,

v.

DAVE JONES, COMMISSIONER OF INSURANCE, ET AL.
Respondents.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE CALIFORNIA COURT OF APPEAL, THIRD DISTRICT

BRIEF FOR THE CALIFORNIA COMMISSIONER OF INSURANCE IN OPPOSITION

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QUESTION PRESENTED

Whether an insurance premium that was determined under a formula designed to permit an insurance company to realize a return on investment of six percentage points above the risk-free rate of return must be held confiscatorily low under the Takings Clause based on the company's purely theoretical analysis of returns available to other companies with similar market capitalizations, when the evidence showed that the regulated rate was not harming the company's ability to pay shareholder dividends, restricting its access to capital, or otherwise preventing it from operating successfully.

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STATEMENT

1. Before 1988, "California ha[d] less regulation of insurance than any other state." *King v. Meese*, 43 Cal. 3d 1217, 1240 (1987) (Broussard, J., concurring). Under the "'open competition' system of regulation, … rates [were] set by insurers without prior or subsequent approval by the Insurance Commissioner." *20th Century Ins. Co. v. Garamendi*, 8 Cal. 4th 216, 243 (1994). Widespread dissatisfaction with this system led voters, in 1988, to enact Proposition 103 with the goal of making residential and automobile insurance more affordable and more widely available. *See Calfarm Ins. Co. v. Deukmejian*, 48 Cal. 3d 805, 812-813 (1989) (quoting the proposition's finding that insurance was "'both unaffordable and unavailable to millions of Californians'"). Among other things, the initiative established a "prior approval" system under which property and casualty "'insurance rates … must be approved by the [State's Commissioner of Insurance] prior to their use.'" *20th Century*, 8 Cal. 4th at 242 (quoting Cal. Ins. Code § 1861.01(c)).

Under the prior-approval system, insurers must file proposed rate changes with the Commissioner. Cal. Ins. Code § 1861.05(b). The Commissioner notifies the public and reviews the application for compliance with California law. *Id.* § 1861.05(c). An application is deemed approved within 60 days unless the Commissioner determines that a hearing is necessary, in which case an administrative law judge receives evidence and issues a proposed decision. *Id.* §§ 1861.05(c), 1861.08(a), 1861.055. The Commissioner may adopt, amend, or reject the ALJ's proposed decision. *Id.* § 1861.08(c); Cal. Gov. Code § 11518.5. The Commissioner's decision, in turn, is subject to judicial review, Cal. Ins. Code § 1861.09, with the reviewing court required to "exercise its independent judgment" and "annul" the order if the "weight of the evidence" does not "support[] the findings, determination, rule, ruling or order of the commissioner," *id.* § 1858.6.

A rate may not be approved if it is "excessive, inadequate, unfairly discriminatory or otherwise in violation of [the Insurance Code]." Cal. Ins. Code § 1861.05(a). Under governing regulations, a rate is "inadequate" if it fails to provide "the opportunity to earn a fair return on the investment that is used to provide the insurance," 10 Cal. Code Regs. § 2642.3, and a rate is excessive if it is "expected to yield the reasonably efficient insurer a profit that exceeds a fair return," *id.* § 2642.1. A "fair return" is defined as "the profit an investor can reasonably expect to earn from an investment in a business other than insurance subject to regulation … presenting investment risks comparable to the risks presented by insurance." *Id.* § 2642.2. Based on a historical analysis of the cost of capital, current regulations recognize the maximum permitted after-tax fair rate of return as the risk-free rate of capital plus 6%—a rate that the Commissioner may increase or decrease by up to 2% if "financial market conditions [are] such that the difference between the risk-free rate and the cost of capital is significantly different from its historical average." *Id.* § 2644.16(a), (c).[1] The system is intended to "yield a premium [that

[1] The rule, which was adopted in response to "comments made in … several workshops," is based on various econometric models as well as "experience gained in many years of case-by-case rate determinations." California Department of Insurance, Updated Informative Digest: Policy Statement Overview and Effect of Proposed Action, RH05042749, at 17 (Nov. 16, 2006), available at http://www20.insurance.ca.gov/pdf/REG/90709.pdf.

allows the insurer] to earn a sum amounting to (1) the reasonable cost of providing insurance and (2) the capital used and useful for providing insurance multiplied by a fair rate of return." *20th Century*, 8 Cal. 4th at 251.

When reviewing an insurer's rate application under the regulations, the Department of Insurance determines a "maximum permitted earned premium" and a "minimum permitted earned premium" for the insurer's product. 10 Cal. Code Regs. §§ 2644.2, 2644.3. Each is calculated by a formula whose inputs include a combination of company-specific and industry-wide data regarding projected losses, investment income, and efficiency expectations. *Id.* §§ 2644.2, 2644.3; *compare, e.g.*, *id.* § 2644.4(a) (defining the formula input for "projected losses" as "the insurer's historic losses"), *and id.* § 2644.7 (requiring each company to calculate a "loss trend" input "using the insurer's most actuarially sound company-specific … data"), *with id.* § 2644.12(a) (instructing the Commissioner to set the efficiency-standard ratio at a number "which represents the fixed and variable cost for a reasonably efficient insurer to provide insurance and to render good service to its customers"), *and id.* § 2644.17 (requiring use of "industry-wide leverage factors" for each type of insurance). Insurers may charge any rate that is between the formulaic maximum and minimum.

Alternatively, insurers may seek to charge a rate outside the formulaic maximum and minimum by requesting one or more variances based on the insurer's particular situation. 10 Cal. Code Regs. § 2644.27. For instance, variances may be available if the insurer provides a "[h]igher quality of service"; if the insurer's mix of business within a particular line "presents investment risks different from the risks that are typical of the line as a whole"; if the insurer is making a "substantial investment" to enter a new market; if the insurer requires higher premiums to protect against insolvency; or if the formula's calculations for loss and premium trends do not "produce an actuarially sound result." *Id.* § 2644.27(f)(1)-(8).

Another variance, at issue here, applies if "the maximum permitted earned premium would be confiscatory as applied." 10 Cal. Code Regs. § 2644.27(f)(9). This variance, which the court of appeal in this case referred to as the "constitutional variance," Pet. App. 2a n.2, is "an end result test applied to the enterprise as a whole," and is intended to supply "the constitutionally mandated variance articulated in [the California Supreme Court's decision in] *20th Century v. Garamendi* (1994) 8 Cal. 4th 216," 10 Cal. Code Regs. § 2644.27(f)(9).

2. In 2009, petitioner Mercury Casualty Company filed an application proposing to increase its rates for three lines of residential insurance: HO-3 (residential homeowners' insurance), HO-4 (tenants' insurance), and HO-6 (condominium owners' insurance). Pet. App. 62a. Mercury initially sought an overall rate increase of 3.9%. *Id.* at 6a. It subsequently amended its request to seek "an overall rate increase of 6.9%, and alternatively, an increase of 8.8% if its request for a variance were granted." *Id.* at 62a. Staff from the Department of Insurance opposed Mercury's requested rates as excessive.[2] The consumer group Consumer Watchdog, which is a respondent here, urged rejection of Mercury's proposal as well. Pet. App. 6a-7a.

Mercury contested aspects of the Department staff's application of the regulatory formula, including

[2] In proceedings before the Commissioner, staff from the Department of Insurance function as a separate party advocate.

the staff's characterization of Mercury's advertising expenses as "institutional advertising expenses" that should be excluded under the ratemaking formula because they were "not aimed at obtaining business for a specific insurer and not providing consumers with information pertinent to the decision whether to buy the insurer's product." Pet. App. 8a; *see* 10 Cal. Code Regs. § 2644.10(f).

Mercury also sought a variance under § 2644.27(f)(9), claiming that the formula rate would be confiscatory. Based on the written testimony of two witnesses, Robert Hamada and David Appel, Mercury claimed that the formula-derived maximum premium rates would be confiscatory as applied, on the theory that they failed to provide a fair rate of return on Mercury's investment. Pet. App. 6a-7a. Dr. Hamada opined that a fair return should be calculated based on the market capitalization of Mercury Insurance Group's stock and outstanding debt, the estimated portion of that total market value that supported the insurance lines at issue, and real-world equity returns on investments of that size for firms with similar risks. A.R. 2464-2475.[3] He opined that such a rate of return required annual premiums of $14 million to $18 million above the maximum permitted premiums under California's formula, *id.* at 2479-2480, and that if Mercury could not realize the rate of return established by his calculations then it could be unwilling to invest new capital in expanding or maintaining its business, *id.* at 2466. Dr. Appel seconded many of Dr. Hamada's opinions, and additionally opined on his understanding of the legal requirements of various federal and state court cases. *Id.* at 2447-2448.

[3] A.R. refers to the Administrative Record that was filed in the reviewing courts below; C.A. App. refers to the Appendix in the court of appeal.

The ALJ struck portions of Dr. Hamada's and Dr. Appel's testimony as irrelevant, because Mercury had not shown that "the maximum earned premium under the ratemaking formula results in an inability to operate successfully" or would cause "'deep financial hardship.'" *See* Pet. App. 7a, 30a. The ALJ also determined that much of the testimony was an attempt to impermissibly relitigate the correctness of the Commissioner's regulations, which Mercury could only challenge in a separate judicial proceeding. *See* C.A. App. 80-81 (ALJ decision); 10 Cal. Code Regs. § 2646.4(c) (relitigation bar); Cal. Gov. Code § 11350 (general provision for judicial review of regulations).

The ALJ's proposed decision recommended approval of a rate increase in two of the policies at issue and a rate decrease in the other. Pet. App. 9a-10a (noting ALJ's approval of an 8.18% rate decrease for Mercury's HO-3 homeowners' policies, a 4.32% increase for the HO-4 tenants' insurance policies, and a 29.44% increase for the HO-6 condominium policies). The net effect was a rate decrease of about 5% for Mercury's overall homeowners' line. *Id.* at 63a n.3. The ALJ rejected Mercury's arguments about institutional advertising expenses. *Id.* at 9a. She also rejected Mercury's argument that a variance was necessary to avoid confiscation. *Id.* Rather than cause "deep financial hardship," the ALJ found, the formula rate would permit Mercury to earn a profit of "at least" $1.8 million on its homeowners' insurance line. *Id.* at 84a-85a. Nor was there evidence that the rates would "impair the company's financial integrity," given that Mercury had maintained an A+ financial strength rating with AM Best, had a "robust policyholder surplus," and had paid its investors over a billion dollars in dividends during the past five years while operating with rates approved under the same regulations. *Id.* at 85a.

The Commissioner adopted the ALJ's decision in full. Pet. App. 9a.

3. Mercury petitioned for review of the Commissioner's order in the Sacramento County Superior Court. Pet. App. 10a. A coalition of insurance trade groups, who are Mercury's co-petitioners here, intervened in support of Mercury. Respondent Consumer Watchdog again intervened in support of the Commissioner. *Id.*

Mercury argued extensively over the Commissioner's disallowance of "institutional advertising expenses" under the formula, Pet. App. 62a, 90a-96a—a claim that Mercury does not renew here. Mercury also raised the constitutional taking claim that is at issue in this petition. *Id.* at 61a-62a. Mercury argued that the Commissioner had not applied a "deep financial hardship" test for confiscation in other cases, and should not have done so here. *Id.* at 84a. Instead, Mercury maintained, the question was whether, with regard to a specific rate application, Mercury's "ability to earn a return is commensurate with the returns on investments in other similar[ly] risky enterprises." *Id.* at 80-81a.

The trial court affirmed the use of the "deep financial hardship" test as the threshold for determining whether the rate under the regulations was "confiscatory." Pet. App. 81a. In explaining what deep financial hardship means, the court relied on the California Supreme Court's summary, in *20th Century*, of this Court's decision in *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). *Id.* at 81a-83a. *20th Century* explained that a "regulated entity may experience 'deep financial hardship' 'when it does not earn enough revenue for both "operating expenses" and "the capital costs of the business," including "service on the debt and dividends on the stock," of a magnitude that would allow a "return to the equity owner" that is "commensurate with returns on investments in other enterprises having corresponding risks" and "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."'" *Id.* at 82a (quoting *20th Century*, 8 Cal. 4th at 296 (quoting *Hope Natural Gas*, 320 U.S. at 603) (emphasis omitted)). Like the ALJ, the court considered Mercury's A+ rating, its robust policy surplus and high dividend payments, and its expected profit under the formula. *Id.* at 84a-85a. Under these circumstances, the court concluded, a company's interest in earning a higher profit than the formula envisioned was only "one variable in the 'constitutional calculus of reasonableness,'" *id.* at 81a (quoting *20th Century*, 8 Cal. 4th at 298-299 (quoting *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 769 (1968))), and did not justify a further increase here.

4. At the state court of appeal, Mercury and the trade organizations again pressed their arguments that the Commissioner and lower courts had erred in disqualifying certain advertising expenses from consideration as part of the rate calculation—contending, among other things, that its advertising expenses were not excludable institutional advertising expenses under the applicable regulation, and that if they were then the regulatory exclusion violated the First Amendment. Mercury C.A. Br. 30-40; Pet. App. 25a. Like the trial court, the court of appeal rejected the argument. Pet. App. 13a-30a.

Mercury also argued that the Commissioner had erred in failing to grant it a variance based on the allegedly confiscatory nature of the formula rate. Pet. App. 31a. The court recounted that *20th Century* allowed a confiscatory-rate claim only "'if the rate in question does not allow [the entity] to operate successfully.'" *Id.* at 35a. *20th Century* had quoted Judge Bork's opinion for the en banc D.C. Circuit in *Jersey Central Power & Light v. FERC*, 810 F.2d 1168 (D.C. Cir. 1987) (en banc), which had explained that the danger of a taking arises only "when a [regulated firm] is in the sort of financial difficulty described [in the *Hope* opinion], viz., 'deep financial hardship.'" Pet. App. 36a (quoting *20th Century*, 8 Cal. 4th at 296 (quoting *Jersey Central*, 810 F.2d at 1181 n.3)); *see also id.* at 37a ("'At least in the general case, such as this, confiscation does indeed require 'deep financial hardship' within the meaning of *Jersey Central*.'" (quoting *20th Century*, 8 Cal. 4th at 297)).

Under the *Jersey Central* conception of deep financial hardship, "'a regulated firm may claim that a rate is confiscatory only if the rate does not allow it to operate successfully,'" Pet. App. 36a — for instance,

> when it does not earn enough revenue for both 'operating expenses' and 'the capital costs of the business,' including 'service on the debt and dividends on the stock,' of a magnitude that would allow a 'return to the equity owner' that is 'commensurate with returns on investments in other enterprises having corresponding risks' and 'sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.'

Id. at 35a-36a (quoting *20th Century*, 8 Cal. 4th at 296 (discussing *Jersey Central* and quoting *Hope Natural Gas*, 320 U.S. at 603)). Because that was the standard that the Commissioner and lower court had applied, the court of appeal found no error. *Id.* at 38a, 41a.

The California Supreme Court denied petitioners' petition for review. Pet. App. 98a.

ARGUMENT

The court of appeal's decision upholding the Commissioner's rate determination does not conflict with this Court's precedents or with the holdings of other lower courts. No further review is warranted.

1. The court of appeal's decision accords with this Court's precedents on the constitutional limitations that apply to rate regulation.

States and the federal government have a general power to regulate the rates charged by commercial enterprises. *See In re Permian Basin Area Rate Cases*, 390 U.S. 747, 768 (1968). The Fifth and Fourteenth Amendments, however, require that those regulations not limit such companies "to a charge for their property serving the public which is so 'unjust' as to be confiscatory." *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307 (1989); *see FPC v. Texaco, Inc.*, 417 U.S. 390, 391-392 (1974) ("All that is protected against, in a constitutional sense, is that the rates … be higher than a confiscatory level."). To establish such confiscation, it is not enough for the entity to show that its return on investment has been lowered or the value of its property reduced. *Permian Basin*, 390 U.S. at 769. Rather, confiscation occurs only if the rate is set so low that "the State has taken the use of [the regulated entity's] property without paying just compensation." *Duquesne Light*, 488 U.S. at 308.

Courts for many years required a specific method for determining whether a rate was confiscatory: "the 'fair value' approach," under which a company was "'entitled to ask … a fair return upon the value of that which it employs for the public convenience.'" *Duquesne Light*, 488 U.S. at 308 (quoting *Smyth v. Ames*, 169 U.S. 466, 547 (1898)). This Court abandoned that rule in the "landmark case" of *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). *Duquesne Light*, 488 U.S. at 310.

After *Hope Natural Gas*, no "particular method of rate regulation is so sanctified" as to be presumptively required. *Wisconsin v. FPC*, 373 U.S. 294, 309 (1963); *see id.* ("[N]o single method need be followed … in considering the justness and reasonableness of rates."); *Duquesne Light*, 488 U.S. at 316 ("[T]he adoption of a single theory of valuation as a constitutional requirement would be inconsistent with the view of the Constitution this Court has taken since *Hope Natural Gas*.").[4]

Instead, *Hope Natural Gas* established, "[i]t is not theory but the impact of the rate order which counts." 320 U.S. 602; *see Duquesne Light*, 488 U.S. at 310 ("reaffirm[ing]" this language from *Hope Natural Gas*). What matters is, essentially, the company's ability to continue operating as a profitmaking concern:

> Rates which enable [a] company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risk assumed certainly cannot be condemned as invalid, even though they might produce

[4] *Wisconsin v. FPC* (like *Hope Natural Gas* and *Permian Basin*) applied the statutory requirements that rates be "just and reasonable" under the Natural Gas Act. Its holdings, however, are authority for the applicable constitutional standard because "the just and reasonable standard of the Natural Gas Act 'coincides' with the applicable constitutional standards." *Permian Basin*, 390 U.S. at 770.

> only a meager return on the so called 'fair value' rate base.

Duquesne Light, 488 U.S. at 310 (quoting *Hope Natural Gas*, 320 U.S. at 605). Within these limitations, States are free to devise methods of price regulation "capable of equitably reconciling diverse and conflicting interests." *Permian Basin*, 390 U.S. at 767.

One method States may use is to rely on collective data about an industry, rather than basing rates on the costs and returns of each individual regulated entity. In *Permian Basin*, this Court considered a Federal Power Commission order prescribing maximum rates for natural gas from all wells within the 60-county region in Texas and New Mexico known as the Permian Basin area. 390 U.S. at 754.[5] The order imposed on each producer a rate based not on the individual producer's investments, but instead on nationwide "composite cost data, obtained from published sources and from producers through a series of cost questionnaires." 390 U.S. at 761; *see id.* ("This information was intended in combination to establish the national costs in 1960 of finding and producing gas-well gas."). Producers challenged the order, arguing that the rate for each producer should be based on that producer's own investments and costs, *id.* at 768—costs that could differ greatly from the composite costs due to the unpredictability of gas exploration, *see id.* at 762.

This Court rejected the argument, holding that the Constitution does not prohibit "the determination of rates through group or class proceedings," and that "legislatures and administrative agencies may calculate rates for a regulated class without first evaluating

[5] *See* Area Rate Proceeding, Claude E. Aikman, N. Cent. Oil Corp. (Operator), 24 F.P.C. 1121, 1125 (Dec. 23, 1960).

the separate financial position of each member of the class." *Permian Basin*, 390 U.S. at 769. In upholding the use of such a method, the Court made reference to two factors that it deemed relevant in that case, though not necessarily required "in every situation." *Id.* at 770. First, the FPC had declared that an individual producer could apply for some form of "appropriate relief" if it could "establish[] that its out-of-pocket expenses in connection with the operation of a particular well exceed its revenue from the well" under the regulated price. *Id.* at 770-771 (internal quotation marks omitted). Second, the Court deemed it "pertinent" that the FPC was likely to "permit[] abandonment" of individual activities in the regulated area that were unprofitable under the rates. *Id.* at 772.

As the court of appeal correctly concluded, the Commissioner's evaluation of Mercury's proposed rates was in accord with these precedents. The Commissioner's regulations were designed to provide to every insurer a "fair return," defined as "the profit an investor can reasonably expect to earn from an investment in a business other than insurance subject to regulation … presenting investment risks comparable to the risks presented by insurance." 10 Cal. Code Regs. § 2642.2. Based on historical data, the Commissioner concluded that such a return would equal the risk-free rate of capital plus 6%, with allowances for additional adjustments if current capital conditions differ from historical conditions. *Id.* § 2644.16; *see* p. 2, *supra*. In determining the premiums that would allow an insurer to realize such a return, the Commissioner employed a formula that relied in part on data about insurance costs and operations on an industry-wide basis, as permitted by *Permian Basin*. *See, e.g.*, 10 Cal. Code Regs. § 2644.12 (instructing Commissioner to calculate efficiency-standard ratios for various types of insurance based on average industry experience).

As in *Permian Basin*, the Commissioner's formula is accompanied by two safeguards. First, Mercury does not dispute that California law provides it with the ability to "abandon[]" any unprofitable activities. *Permian Basin*, 390 U.S. at 772. Property and casualty insurers such as Mercury have no legal obligation to remain in the California homeowners' insurance market, and may choose to exit that market for any reason. Mercury's and other companies' decisions to continue selling those products under California's regulations presumably reflect their judgment that they do in fact earn a satisfactory return. In this respect, Mercury's judgment accords with that of the Commissioner, whose approval criteria are aimed at attracting firms to California and increasing competition—not driving insurers away.[6]

Second, California provides a method for insurers to receive relief if the otherwise fair rate would be unconstitutionally confiscatory. Mercury argues that California law expressly rejects the principle that an insurance company should receive a fair return on its investment. Pet. 9, 14. But the court of appeal never held that insurance companies are not entitled to a "fair rate of return" (Pet. 3), let alone "denied that a 'fair rate of return' had any place in the constitutional analysis" (Pet. 8). And California's regulations expressly require that formulas be designed to yield a

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[6] *See* California Department of Insurance, CDI's Vision, Mission, Values, and Goals, available at http://www.insurance.ca.gov/0500-about-us/vmvg.cfm (noting the Department's mission to "ensure vibrant markets").

"fair rate of return," defined with reference to available returns from other investments with similar risks. *See* 10 Cal. Code Regs. § 2642.2 (stating that insurers should receive a "fair return," defined as that which would be earned on "an investment in a business other than insurance … presenting investment risks comparable to the risks presented by insurance").

The court of appeal did not reject the use of a fair-return standard in general; rather, it rejected "[t]he 'fair rate of return' standard *espoused by Mercury*." Pet. App. 38a (emphasis added). The Mercury-espoused standard would require calculating a fair return for each company based on stock market capitalization, without regard to the investments the company actually devotes to the business at hand and without regard to whether the company is achieving the efficiencies that other insurers have achieved. Mercury's method may or may not be an acceptable method of calculating a fair return, but it is not the only method that is constitutionally permissible. *See Duquesne Light*, 488 U.S. at 316 ("The adoption of a single theory of valuation as a constitutional requirement would be inconsistent with the view of the Constitution this Court has taken since *Hope Natural Gas*."); *Wisconsin*, 373 U.S at 309 ("[N]o single method need be followed … in considering the justness and reasonableness of rates."). Indeed, many components of Mercury's methodology have been specifically rejected by this Court.[7]

[7] A company is not entitled to an investment return based purely on its overall market capitalization. *See Covington & L. Turnpike Road Co. v. Sandford*, 164 U.S. 578, 596 (1896) (regulated toll road had no right "to realize a given per cent upon its capital stock"). Nor is a company entitled to achieve a certain return regardless of the company's efficiency or prudence. *See*

The decisions below also resulted from Mercury's inability to show that the "end result" of the prices arrived at under the regulatory formula would nonetheless cause the kinds of harm that this Court has identified as relevant in determining that a regulatory formula designed to yield a fair return is nonetheless confiscatory in an individual case—*i.e.*, the harms of undercutting the company's "financial integrity," "operating capital," and ability to "'compensate its investors'" and "raise future capital." *Duquesne Light,* 488 U.S. at 310, 312; *see* pp. 6, 8, *supra* (noting that Mercury's previous experience charging rates approved under the regulations had not interfered with the company's ability to pay substantial dividends and enjoy a superior credit rating).[8]

2. The court of appeal's decision likewise creates no conflict with the decisions of other lower courts.

Permian Basin, 390 U.S. at 770 ("No constitutional objection arises from the imposition of maximum prices merely because 'high cost operators may be more seriously affected … than others.'"); *id.* at 825 n.115 (perceiving "no obligation upon the Commission, under the Constitution …, to permit recovery of all exploration costs, regardless of their amount and prudence").

[8] In this respect, California's variances go further than what the Court found constitutionally sufficient in *Permian Basin*. The FPC, in *Permian Basin*, contemplated relief only for producers who would otherwise be forced to operate at a loss. *See Permian Basin*, 390 U.S. at 770-771 (FPC order contemplated relief "if [the producer] establishes that its out-of-pocket expenses in connection with the operation of a particular well exceed its revenue from the well" under the FPC rate (internal quotation marks omitted)). In contrast, neither the Commissioner nor any California court has held that an insurer must actually operate at a loss to receive relief under the California regulations' "constitutional" variance. *See* pp. 18-19, *infra*.

a. Petitioner claims that the decision below conflicts with decisions by the Sixth, Ninth, and D.C. Circuits. Pet. 10-12. That is incorrect.

Michigan Bell Telephone Co. v. Engler, 257 F.3d 587 (6th Cir. 2001), involved a Michigan statute that froze certain telephone rates. *Id.* at 591. Various other provisions of Michigan law allowed increases only to "account[] for the *cost* of providing services," *id.* at 595, without "consider[ing] the need for a return on investment," *id.* at 596. The court held that "providing for a return which only covers costs is inadequate under well-established due process standards," *id.* at 596, and that the law was unconstitutional for failing to provide the service providers any way to seek a "fair and reasonable rate of return," *id.* at 593-594. The case has little relevance to this one, since California's regulations are designed to allow an insurer not only to cover costs, but also to realize a "fair rate of return" on its investment. *See* p. 2, *supra*; Pet. 5 (quoting C.A. App. 1443).

Guaranty National Insurance Co. v. Gates, 916 F.2d 508 (9th Cir. 1990), involved a Nevada law freezing automobile insurance rates. *Id.* at 510. The statute allowed an insurer relief from the rate-freeze only if the insurer could show that it was "substantially threatened with insolvency"—that is, the condition in which "'the sum of the insurer's debts is greater than all of the insurer's property.'" *Id.* The Nevada insurance law (like the telecommunications law in *Michigan Bell*) required only that the insurer be permitted to charge rates at or above the "break even" level. *Id.* at 512. The Ninth Circuit concluded that neither the insolvency standard nor the guarantee of a "break-even" return provided an adequate mechanism to guarantee a "constitutionally required fair and reasonable return." *Id.* at 512, 515.

That presents no conflict with California law. The California Supreme Court has held that it would be unconstitutional to allow insurers relief from a rate freeze only if they were "substantially threatened with insolvency." *Calfarm v. Deukmejian*, 48 Cal. 3d 805, 815 (1989); *see id.* at 818 (explaining that allowing relief only to those threatened with insolvency would not "conform to the constitutional standard of a fair and reasonable return"); *id.* at 818 n.9 ("If 'insolvency' is defined as 'bankruptcy,' it is clear that rate relief cannot be confined to companies threatened with insolvency." (citing *Hope Natural Gas*, 320 U.S. at 603)). The Ninth Circuit's decision in *Guaranty National* not only reached the same result as the California Supreme Court in *Calfarm*, but relied substantially on *Calfarm* to do so. *See Guaranty National*, 916 F.2d at 512-513, 515-516 (discussing *Calfarm*).[9] In accordance with *Calfarm*'s requirements, the Commissioner

[9] The California Supreme Court, in *20th Century*, commented that language in *Guaranty National* could be "read to erroneously state that the producer is constitutionally 'guarantee[d]' a 'fair and reasonable return[,]' and that such a return must necessarily be above the 'break even' level." Pet. App. 36a (quoting *20th Century*, 8 Cal. 4th at 294 n.18). That comment simply reflects that *Guaranty National* should not be read as overruling longstanding precedent that the fair-return principle does not "guarantee" a return or profit in all circumstances. *See Market St. Ry. Co. v. Ry. Comm'n of Cal.*, 324 U.S. 548, 556, 567 (1945) (regulated rate need not prevent losses brought on by "the operation of economic forces" or "mismanagement"); *Duquesne Light*, 488 U.S. at 302 (where an investment was prudent when made but is no longer "used and useful," regulator may exclude the investment from the rate-base on which the return is calculated). For instance, *Pennsylvania Electric Co. v. Pennsylvania Public Utilities Commission*, 509 Pa. 324 (1985), upheld the exclusion of a damaged nuclear reactor from two utilities' rate-base under the "used and useful" method, even though the result was the companies' "diminished financial viability." *Id.* at 326. This

and the courts below rested their decisions not on Mercury's mere solvency, but on the company's access to credit, ability to pay dividends, and ability to operate successfully, as specified in *Hope Natural Gas*. *See* pp. 6-7, *supra*.

Finally, *Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168 (D.C. Cir. 1987) (en banc), concerned a utility that claimed it was facing "serious financial difficulty." *Id.* at 1171. When the utility requested a rate increase in "'the minimum amount necessary to restore [its] financial integrity,'" *id.*, FERC denied the rate increase without a hearing and without making any findings, *id.* at 1173. The court of appeals reversed. In striking contrast to Mercury here, the utility in *Jersey Central* had submitted evidence that it had paid no dividends on its common stock for four years, maintained a poor credit rating, and had no access to long-term capital and only limited access to short-term capital. *See id.* at 1171, 1174. The court held that this was evidence of "the sort of deep financial hardship described in *Hope*"—"the only circumstance" in which a rate regulation threatens the "possibility of a taking." *Id.* at 1181 n.3. That reasoning does not conflict with what the California court of appeal did here. *Compare* Pet. App. 35a-36a (quoting *20th Century*'s definition of "deep financial hardship" as the "inability to operate successfully" described in *Hope Natural Gas*).

Petitioners emphasize (Pet. 11-12) that *Jersey Central* rejected FERC's argument that confiscation could be shown only if the rate order "would put the

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Court subsequently dismissed the companies' appeal for want of a substantial federal question, *see Metro. Edison Co. v. Penn. Pub. Util. Comm'n*, 476 U.S. 1137 (1986)—a dismissal which constituted a decision by this Court on the merits, *see Hicks v. Miranda*, 422 U.S. 332, 344 (1975).

utility into bankruptcy." *Jersey Central*, 810 F.2d at 1175; *see id.* at 1180 ("*Hope Natural Gas* talks not of an interest in avoiding bankruptcy, but an interest in maintaining access to capital markets, the ability to pay dividends, and general financial integrity."). But the court of appeal's decision here is consistent with that understanding. The court never said that Mercury could receive a "constitutional" variance only if it could show impending bankruptcy. Cases of insolvency are treated under an entirely different variance. *See* 10 Cal. Code Regs. § 2644.27(f)(6). Instead, the court of appeal (like the trial court, Commissioner, and ALJ) evaluated the appropriateness of the "constitutional" variance by examining various aspects of Mercury's financial condition, as the D.C. Circuit held FERC should have done in *Jersey Central*. *See Jersey Central*, 810 F.2d at 1181-1182. In Mercury's case, that examination revealed that the formula rate would not cause the kind of harm that *Jersey Central* describes *Hope* as concerned with: "access to capital markets, … ability to pay dividends, and general financial integrity." *Id.* at 1180.

b. Petitioners are also wrong to claim that the court of appeal's decision conflicts with the decisions of other States' courts. Pet. 12-14.

State Farm Mutual Auto Insurance Co. v. New Jersey, 590 A.2d 191 (N.J. 1991) and *Fitchburg Gas & Electric Light Co. v. Department of Public Utilities*, 7 N.E.3d 1045 (Mass. 2014), each concerned facial challenges to state laws that imposed surcharges on regulated companies and prevented the companies from passing those costs on to consumers. *State Farm*, 590 A.2d at 197-198; *Fitchburg*, 7 N.E.3d at 1056-1057. Both courts, like the court of appeal here (Pet. App. 34a), recognized the investor's interest in a return sufficient to maintain a company's "financial health," *State Farm*, 590 A.2d at 199, and "investor confidence," *Fitchburg*, 7 N.E.3d at 1057. Neither opinion adopted the rule that Mercury advocates, which would guarantee each firm, regardless of its efficiency or management, the same profit on any regulated investment that other investors could receive elsewhere on an investment of similar risk. *See State Farm*, 590 A.2d at 200 (recognizing that a regulator-approved rate may not provide as much profit "'as an investor might obtain by placing his capital elsewhere'" (quoting *Hutton Park Gardens v. Town Council of Town of West Orange*, 350 A.2d 1, 15 (N.J. 1975))).

Stewart v. Utah Public Service Commission, 885 P.2d 759 (Utah 1994), which involved ratepayers' contention that certain telephone rates were too high, did not directly address the point at which rates become too low. *Id.* at 762. The court rejected the telephone company's assertion that its rates should be raised to match the rates of return that its parent company could earn elsewhere. *Id.* at 771-772. Petitioner draws attention (Pet. 13-14) to the case's statement that rates should "produce enough revenue to pay a utility's operating expenses plus a reasonable rate of return on capital invested … include[ing] the cost of debt service and a return on equity capital sufficient to attract investors, given the nature of the risk of the investment." *Id.* at 767. But California's regulations aim to produce a similar return, and the courts below (like the ALJ and Commissioner) relied on objective evidence that these goals were being met. *See* pp. 6, 8, *supra.*

Peoples Natural Gas Co. v. Cities of Bellevue, 254 Neb. 728 (1998), concerned the treatment of environmental remediation costs that a utility wanted to include in its rate base. *Id.* at 730-731. The court held that the utility had failed to prove confiscation because it never established what its rate of return would be under any particular scenario—the return was "concealed within [a] settlement agreement." *Id.* at 732. Petitioner (Pet. 13) attaches significance to the case's statement that confiscation occurs "when the rate fails to produce a return on investment equal to the return realized on investments which have risks corresponding to those of the utility." *Id.* at 731. But the statement was not material to the decision in that case. And rather than purporting to apply the *Hope Natural Gas* test, the Nebraska Supreme Court supported that statement by discussing the pre-*Hope* case *Bluefield Co. v. Public Service Commission*, 262 U.S. 679 (1923)—a case decided under the restrictive rule of *Smyth v. Ames*, 169 U.S. 467 (1898), that *Hope Natural Gas* later "abandoned," *Duquesne*, 488 U.S. at 310.

Finally, *Anthem Health Plans of Maine, Inc. v. Superintendent of Insurance*, 40 A.3d 380 (Me. 2012) concerned a challenge to health-insurance rates. *Id.* at 381. Maine law instructed the Superintendent of Insurance to set rates by balancing the effect of a rate on the insurer's "financial integrity" against the public's interest in affordable health insurance. *Id.* at 382. Employing this approach, the Superintendent denied Anthem's request for a rate increase and instead imposed a lower rate which provided only a "1% built-in risk and profit margin." *Id.* at 383. Anthem appealed, asserting that a "fair and reasonable rate of return" must afford a profit margin "consistent with the industry-wide average." *Id.* at 384 (internal quotation marks omitted). Maine's high court rejected Anthem's argument. The court looked to the "financial picture of the regulated insurance lines," which showed that Anthem would earn a profit—though one apparently lower than what Anthem earned on its unregulated lines of insurance. *Id.* at 388. "Because Anthem suffers no losses, and indeed anticipates that it will earn a profit on the rates approved by the Superintendent, neither the rating nor the method used in arriving at the approved rate results in an unconstitutional taking." *Id.* at 389-390. The Maine court's reasoning is consistent with the California courts' reasoning in this case, and does not present a basis for review in this Court.

3. Petitioners' other arguments for certiorari are likewise unconvincing.[10]

Petitioner argues that this case is "unencumbered by the factual or technical issues that ordinarily muddy the waters in cases involving challenges to confiscatory rates," such as "methodological questions regarding 'what is a fair rate of return given the risks under a particular rate-setting system' or 'the amount of capital upon which the investors are entitled to earn that return.'" Pet. 21 (quoting *Duquesne*, 488 U.S. at 310). That is incorrect. All parties agree that rates should be set with the expectation that they will produce a fair rate of return. The disagreement in this

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[10] Petitioners argue that the court of appeal's decision should be reviewed because it is binding on superior courts throughout the State. Pet. 21-22. A California court of appeal's decision is not, however, binding in future appellate cases. *See Sarti v. Salt Creek Ltd.*, 167 Cal. App. 4th 1187 (2008). To the extent that Mercury complains (Pet. 4-5, 8) about the court of appeal's purported misapplication of the California Supreme Court's *Calfarm* and *20th Century* precedents, another California court of appeal remains free to rule differently in a future case, with any dispute likely to be settled by the California Supreme Court. *See* Cal. R. Ct. 8.500(b)(1).

case substantially concerns what the fair rate of return in this product is under current market conditions. *See* p. 15, *supra*.[11]

Petitioners profess concern about the "enterprise as a whole" approach to evaluating the end result of a rate regulation, alleging (with little elaboration) that such an approach "could force national insurers to use money earned in other States to support policies in California." Pet. 23 (emphasis omitted). But petitioners' fear is entirely conjectural: neither here nor in the proceedings below has Mercury even alleged, let alone demonstrated, that the rate-decision in this case would lead to cross-subsidization.[12] Nor does California's rate formula operate to promote such cross-subsidization. *See, e.g.*, 10 Cal. Code Regs. § 2644.17

[11] Mercury asserts that "[t]he principal issue below was whether the Commissioner and the trial court had 'erred in holding that rates are constitutionally confiscatory only if they result in financial distress, rather than simply in the inability to earn a fair return.'" Pet. 20 (quoting Pet. App. 31a). In fact, the quoted statement is the court of appeal's description of Mercury's *contention*—not the issue that the court of appeal decided. The issue actually decided was whether Mercury's particular method of calculating a fair rate of return had to be given preference over the Commissioner's method.

[12] Indeed, cross-subsidization from non-California ratepayers would seem unlikely given that non-California policies represented less than 15% of Mercury's residential insurance business at the time. *See* Mercury General Corp. Form 10-K Annual Report for Fiscal Year Ended December 21, 2008, p. 2, available at https://www.mercuryinsurance.com/resources/investor-information/AR/Mercury_General-AR2008.pdf; *compare Anthem*, 40 A.3d at 388 ("To say that Anthem might occasionally need to use its substantial company-wide surplus, which we agree is funded in large part by the financial success of its unregulated group insurance products, to pay for intermittent losses sustained by the individual lines, is both in form and substance a different statement than saying that its group consumers are in fact being charged higher rates in order to subsidize the regulated lines.").

(calculating surplus ratio specific to a particular line); *id.* § 2644.12(b) (calculating efficiency standard specific to a particular line). The "enterprise as a whole" concept has application only where a company alleges that the formula's otherwise acceptable method of rate evaluation would not, in the company's particular case, enable it "to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risk assumed." *Duquesne Light*, 488 U.S. at 310 (quoting *Hope Natural Gas*, 320 U.S. at 605). In any event, there are important justifications for the "enterprise as a whole" approach—including the need to prevent companies from opportunistically allocating investment assets in such a way as to artificially depress investment returns (and justify higher premiums) in a particular segment of business. If the "enterprise as a whole" approach is to be reviewed, that should happen in a case where the insurer proposed a definition of "enterprise" and presented evidence of financial impact on the enterprise under that definition—steps Mercury neglected to take in these proceedings.

Petitioners argue that the issues in this case require resolution because governmental rate regulation is widespread. Pet. 24. But most constitutional challenges to rate regulation occur in the context of public utilities, as reflected by the cases petitioners cite throughout their brief. *See also* Chamber of Commerce Br. 11 (discussing "power generators, gas companies, sewer operators" and "telecommunications providers"). The insurance business differs markedly from that of public utilities. A utility's investment base largely consists of depreciating physical infrastructure that is rooted in place, making it relatively difficult or impossible for the utility to redeploy existing investments to other industries or other locations.

See id. In contrast, an insurance company's primary investments are in the securities, real estate, and other appreciating assets backing its policies. Moreover, insurance companies are under no duty to serve all customers comparable to that which applies to many utilities. This case thus may shed little light on the law that should apply in other, more typical rate-setting scenarios.[13]

[13] Amici argue that the holding below poses particular risk to the market in Long Term Care Insurance (LTCI). *See* Chamber of Commerce Br. 8-11. In fact, the decision below will have no direct effect on LTCI rates, because California law provides the Commissioner with no comparable rate-approval authority over LTCI, which is not covered by Proposition 103. To the extent there have been pricing disputes over LTCI in other States, those disputes likely reflect features unique to LTCI. In particular, LTCI has an unusual history of initial underpricing by the industry, due in part to overly optimistic assumptions, which has led to later extreme rate increase requests that are seen as problematic for a product designed to be purchased in early adulthood and maintained at a stable rate through an insured's lifetime. *See generally* Society of Actuaries, Long Term Care Insurance: The SOA Pricing Project (Nov. 2016), at 6, available at https://www.soa.org/Files/Sections/ltc-pricing-project.pdf. Whatever the merits of those disputes, they are quite different from those that apply to annual residential property and casualty insurance policies like those at issue here.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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