No. 17-537

IN THE
Supreme Court of the United States

MERCURY CASUALTY CO., ET AL.,
Petitioners,
v.

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

On Petition for a Writ of Certiorari to the California Court of Appeal, Third Appellate District

REPLY BRIEF IN SUPPORT OF CERTIORARI

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RULE 29.6 DISCLOSURE STATEMENT

The Rule 29.6 disclosure statement in the petition for a writ of certiorari remains accurate.

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INTRODUCTION

The Commissioner's brief in opposition is notable for what it does not say. The Commissioner does not dispute that federal courts of appeals and state supreme courts are intractably divided over the question presented: Whether the Constitution permits a State to fix the rates charged by a regulated entity at a level that precludes a fair rate of return on the regulated entity's capital. And the Commissioner appears to concede (at 13-15) that the Constitution and this Court's precedents require that firms be afforded an opportunity to earn a fair rate of return.

The Commissioner's principal response to the petition is instead to insist that the California Court of Appeal did not reject the fair rate of return standard. The Commissioner's effort at evasion falls flat. The

Court of Appeal meant what it said: It held that a government-imposed rate is unconstitutionally confiscatory only where it inflicts "deep financial hardship" on "the enterprise as a whole." Pet. App. 30a, 38a (internal quotation marks omitted). The court expressly rejected the idea that firms must be permitted to earn returns sufficient "to attract capital" and "commensurate with" those "in other enterprises having corresponding risks." *Id.* at 36a (internal quotation marks omitted). And it declared that a "'fair rate of return' standard" "contravenes" the court's "understanding of the constitutional concept of confiscation." *Id.* at 38a (internal quotation marks omitted).

By rejecting the fair rate of return standard, the Court of Appeal's decision exacerbates a clear split and flouts this Court's repeated admonition that the Constitution guarantees regulated firms the opportunity to "maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed." *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 792 (1968); *cf. Duquesne Light Co.* v. *Barasch*, 488 U.S. 299, 312 (1989). Moreover, contrary to the separate arguments of intervenor Consumer Watchdog, the decision below answered a pure question of law that was squarely raised in the briefing below. Accordingly, this case is an ideal vehicle to resolve the question presented.

As *amici* have told this Court, the Court of Appeal's erroneous decision will affect thousands of businesses in the Nation's largest State, and the question presented will have enormous ramifications for businesses and consumers far beyond the State's borders. *See* U.S. Chamber *Amicus* Br. 8-12. This Court's

intervention is urgently needed. The petition should be granted.

REASONS FOR GRANTING THE PETITION

I. THE DECISION BELOW DEEPENS A CLEAR SPLIT IN THE LOWER COURTS

In a bid to avoid the obvious split, the Commissioner asserts (at 15) that the Court of Appeal did not "reject the use of a fair-return standard," and cherry-picks language from courts that have come out the other way (at 17-23). The Commissioner's arguments cannot withstand scrutiny.

1. The Court of Appeal left no doubt about its holding: It concluded that "[t]he 'fair rate of return' standard espoused by Mercury contravenes" the Federal Constitution. Pet. App. 38a. The " 'fair rate of return' standard espoused by Mercury" was not, as the Commissioner asserts (at 15), a *method* of calculating the fair rate of return; rather, it was "the opportunity to earn a 'fair' and 'reasonable' return—that is, 'a return commensurate with returns from investments of comparable risk.' " Mercury C.A. Br. 44 (quoting *Fed. Power Comm'n* v. *Hope Nat. Gas. Co.*, 320 U.S. 591, 603 (1944)).

In rejecting the fair-return standard, the Court of Appeal went a step further than the California Supreme Court in *20th Century Insurance Co.* v. *Garamendi*, 878 P.2d 566 (Cal. 1994). The Court of Appeal concluded that the "deep financial hardship" standard in *20th Century* was *irreconcilable* with a fair rate of return standard. Indeed, under the Court of Appeal's more exacting version of the "deep financial hardship" standard, a rate regulation is confiscatory only if it results in "the inability" of "the enterprise as a whole" to "operate successfully"—that is,

only if it drives regulated firms to the brink of failure. Pet. App. 30a, 38a (internal quotation marks omitted).

2. The Court of Appeal's actual holding runs headlong into the contrary holdings of three federal courts of appeals and many more state high courts.

a. Start with the break between the California Court of Appeal and the Sixth, Ninth, and D.C. Circuits. *See* Pet. 10-12. The Commissioner tries to wave the conflict away by asserting (at 17-19) that the decisions in those circuits involved rates that did not allow firms to break even, whereas Mercury was permitted to earn *some* return on its investment. *See also* Consumer Watchdog Br. 19-23. That is irrelevant; the applicable constitutional standard does not turn on whether a firm breaks even or not. Rather, the Sixth, Ninth, and D.C. Circuits have concluded that—regardless of their circumstances—firms must have the opportunity to earn a fair rate of return. *See Mich. Bell Tel. Co.* v. *Engler*, 257 F.3d 587, 594 (6th Cir. 2001) (rate regulations must "ensure a fair and reasonable rate of return"); *Guar. Nat'l Ins. Co.* v. *Gates*, 916 F.2d 508, 515 (9th Cir. 1990) (rate regulations must "guarantee the constitutionally required 'fair and reasonable return' "); *Jersey Cent. Power & Light Co.* v. *FERC*, 810 F.2d 1168, 1178 (D.C. Cir. 1987) (en banc) (rate regulations must permit firms to "attract necessary capital" and "fairly compensate investors for the risks they have assumed").

The fair rate of return standard embraced by these courts plainly conflicts with the decision below. Because the Court of Appeal concluded that a rate regulation is confiscatory only when it results in

"deep financial hardship," it blessed the Commissioner's refusal to admit Mercury's expert evidence showing that it had been deprived of the opportunity to earn a fair return. Pet. App. 38a. Had the Court of Appeal instead applied the fair rate of return standard that governs in the Sixth, Ninth, and D.C. Circuits, it would have vacated the Commissioner's decision.[1]

b. The Commissioner's attempts to distinguish the Court of Appeal's decision from conflicting state court precedents are similarly unavailing.

The Commissioner argues (at 21) that the state supreme courts in New Jersey and Massachusetts did not "guarantee each firm, regardless of its efficiency or management, the same profit * * * that other investors could receive elsewhere on an investment of similar risk." *See also* Consumer Watchdog Br. 23-24. Again, that is irrelevant. The fair-return standard does not guarantee a particular rate of return; it guarantees "the *opportunity* to realize a fair and reasonable return" sufficient "to maintain investor confidence." *Fitchburg Gas &*

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[1] As explained in the petition, the phrase "deep financial hardship" in the D.C. Circuit's decision in *Jersey Central* referred simply to the absence of a fair return. *See* Pet. 12, 19. The D.C. Circuit did not use that phrase to refer to all situations in which "a firm receives less than its desired rate of return." Consumer Watchdog Br. 20. Nor did the D.C. Circuit—in light of its explicit reference to the specific kind of hardship at issue in *Hope*—use that phrase to refer only to those situations in which a rate regulation imposes "severe strains on the company's financial integrity," as Consumer Watchdog asserts and as the Court of Appeal's decision intimates. *Id.* (internal quotation marks omitted).

Elec. Light Co. v. *Dep't of Pub. Util.*, 7 N.E.3d 1045, 1053 (Mass. 2014) (emphasis added; internal quotation marks omitted). The Court of Appeal's decision cannot be squared with that standard; it fails to guarantee even the *opportunity* to earn a fair rate of return because it offers relief only when a firm as a whole is unable to operate successfully.

The other distinctions the Commissioner draws are even less germane. The Commissioner claims (at 22) that the Nebraska Supreme Court's discussion of the fair rate of return standard "was not material to the decision" in *Peoples Natural Gas Co.* v. *City of Bellevue*, 579 N.W.2d 510 (Neb. 1998). But the whole case turned on whether the utility had demonstrated "the amount of a fair and reasonable rate of return." *Id.* at 513. The Commissioner claims (at 21) that the Supreme Court of Utah "did not directly address the point at which rates become too low." *See also* Consumer Watchdog Br. 26. But the court did just that: It concluded that rates must "produce enough revenue to pay a utility's operating expenses plus a reasonable return on capital invested." *Stewart* v. *Utah Pub. Serv. Comm'n*, 885 P.2d 759, 767 (Utah 1994). The Commissioner alleges (at 22-23) that the decision in *Anthem Health Plans of Maine, Inc.* v. *Superintendent of Insurance*, 40 A.3d 380 (Me. 2012), is consistent with the Court of Appeal's decision because it approved a rate that would permit a firm to "earn a profit." *See also* Consumer Watchdog Br. 24. But *Anthem* made crystal clear that a rate is confiscatory whenever a firm cannot "realize a reasonable return on [its] investment"—a standard that the Court of Appeal expressly rejected here. *Id.* at 389.

Finally, the Commissioner does not even address the New Mexico Supreme Court's decision in *In re Petition of PNM Gas Services*, 1 P.3d 383 (N.M. 2000). With good reason: The court expressly concluded that firms must be able to "earn[] a reasonable rate of return." *Id.* at 391.

In short, there is no getting around the entrenched conflict over the question presented. The Court should grant certiorari and bring clarity and uniformity to this important area of law.

II. THE DECISION BELOW CONFLICTS WITH THIS COURT'S PRECEDENTS

This Court's decisions have long made clear that government-imposed price controls are unconstitutionally confiscatory when they deprive regulated firms of the opportunity to earn a fair return on their invested capital. Pet. 16-19.

1. The Commissioner asserts (at 12-14) that California's rate-setting methodology is constitutional. That is beside the point. "[I]t is the result reached, not the method employed which is controlling." *Hope*, 320 U.S. at 602. California law entitles insurers to a "variance" from the maximum rate of return produced by the Commissioner's rate-setting formula when they can demonstrate that it "would be confiscatory as applied." Cal. Code. Regs. tit. 10, § 2644.27(f)(9). The sole question in this case is whether a rate is unconstitutionally confiscatory when it precludes a fair rate of return. As the petition demonstrates, the Court of Appeal's answer to that pure question of law cannot be squared with this Court's precedents. Pet. 16-20.

The Commissioner offers no basis for disputing that conclusion. Indeed, the Commissioner's insist-

ence (at 14)—despite clear evidence to the contrary, *see supra* pp. 3-4—that the Court of Appeal "never held that insurance companies are not entitled to a 'fair rate of return' " suggests that even the Commissioner believes that the fair-return standard is constitutionally compelled.

2. Consumer Watchdog takes a different approach: It asserts (at 13) that the fair rate of return standard is not a constitutional requirement, but rather just one factor that "must be balanced against the interest of consumers in not paying exploitative rates." That is wrong. As this Court's seminal decision in *Hope* makes plain, the fair-return standard is a constitutional floor, not a "factor."

To be sure, *Hope* indicated that the "rate-making process" must involve "a balancing of the investor and the consumer interests." 320 U.S. at 603. But the Court went on to identify the investor interests that "should" be protected *regardless* of how those interests were balanced: "By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *Id.* The Court took care to note that the opportunity to earn a fair rate of return would not always "insure that the business shall produce net revenues." *Id.* (quoting *Fed. Power Comm'n* v. *Nat. Gas Pipeline Co.*, 315 U.S. 575, 590 (1942)). But the Court was clear that, no matter the balance, the basic preconditions of a fair return must be met.

The Court reiterated that conclusion again in *Permian Basin* and *Duquesne*. Consumer Watchdog protests that the Court indicated that the investor's interest is "only one of the variables in the constitutional calculus." Br. 15-16 (quoting *Permian Basin*, 390 U.S. at 769). But the very next line of the Court's opinion made clear that "rates must be calculated for a regulated class in conformity with the pertinent constitutional limitations." 390 U.S. at 769. And this Court's decision in *Duquesne* removed any doubt that the fair rate of return standard was one such "constitutional limitation."

The Court in *Duquesne* evaluated whether a rate was confiscatory *solely* based on whether the rate had left the companies in that case with "insufficient operating capital," had "imped[ed] their ability to raise future capital," or was "inadequate to compensate current equity holders for the risk associated with their investments"—the core preconditions for a fair rate of return. 488 U.S. at 312. The Court explained that whether a rate is confiscatory would "depend to some extent on what is a fair rate of return given the risks under a particular rate-setting system." *Id.* at 310. Justice Scalia's concurrence echoed that conclusion, explaining that the question "whether the government's action is confiscatory" depended entirely on whether the mandated rates "constitute a fair return on investment." *Id.* at 317 (Scalia, J., concurring).

In short, this Court's cases confirm that the fair-return standard is a constitutional requirement, not just one factor in a balancing test. The Court of Appeal's break from these precedents—in the State with the Nation's largest economy—merits this Court's review.

III. THIS CASE IS AN IDEAL VEHICLE TO RESOLVE AN IMPORTANT QUESTION

The question presented is extremely important; it arises frequently and affects thousands of businesses and consumers each year. Pet. 21-24; *see* U.S. Chamber *Amicus* Br. 8-12. Respondents barely dispute that.[2] Instead, they spend their briefs fly-specking this case's suitability as a vehicle for review. All of their arguments are unavailing.

First, Consumer Watchdog asserts (at 28-30) that petitioners did not present their constitutional arguments below. Nonsense. Even the Commissioner concedes (at 7) that "Mercury also raised the constitutional takings claim that is at issue in this petition" in the California courts. In the Court of Appeal, petitioners argued that the "Commissioner and Superior Court erred in rejecting the 'fair rate of return' standard as the test" of unconstitutional "confiscation." Mercury C.A. Br. 43 (capitalization altered); *see* Trades C.A. Br. 36. The Court of Appeal answered that question directly. Pet. App. 38a. Petitioners' unsuccessful petitions for review in the California Supreme Court likewise presented the question whether a "fair rate of return" or "deep financial hardship" was "the proper test for determining whether a rate is confiscatory." Mercury Pet. for Review 9; Trades Pet. for Review 4. The question presented was thus both pressed and passed upon below.

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[2] The Commissioner asserts (at 25) that the "insurance business differs markedly from that of public utilities." But those differences have no bearing on the constitutional standard applicable to rate regulations in either industry.

Second, the Commissioner asserts (at 24) that this case presents a fact-bound dispute that "substantially concerns what the fair rate of return in this product is under current market conditions." *See also* Consumer Watchdog Br. 3, 18. That is not true. Because the Court of Appeal resolved a pure question of law, it had no need to—and did not—address the parties' underlying factual dispute. Indeed, precisely because the Court of Appeal *rejected* the fair rate of return standard, "the fair rate of return * * * under current market conditions" was ultimately irrelevant. This is the rare rate-setting case in which the question presented is cleanly teed up for review. *See* Pet. 20-21.

Third, the Commissioner argues (at 16) that the record does not demonstrate that Mercury's rates would have been confiscatory even under a fair rate of return standard. *See also* Consumer Watchdog Br. 3-4. But Mercury never had the chance to make that showing, even though it tried to offer evidence to that effect. Because the Commissioner applied a "deep financial hardship" standard instead of a "fair rate of return" standard, he barred Mercury from presenting expert testimony showing that it was denied a fair rate of return. Pet. App. 7a-10a; *see* Pet. 6-7. The lack of evidence is thus the consequence of the Commissioner's and the California courts' erroneous answer to the question presented; it is no basis to deny review.

Finally, this case presents a textbook example of a dispute "capable of repetition" yet "evading review." *Turner* v. *Rogers*, 564 U.S. 431, 439 (2011) (internal quotation marks omitted). This Court has held that when a temporary action like a government-imposed rate "is in its duration too short to be fully litigated

prior to its cessation or expiration" and "there is a reasonable expectation that the same complaining party will be subjected to the same action again," a "case based on that dispute remains live" even though the rate may have expired. *Id.* (quoting *Weinstein* v. *Bradford*, 423 U.S. 147, 149 (1975) (per curiam) (brackets omitted)); *see Nat'l Ass'n of Greeting Card Publishers* v. *U.S. Postal Serv.*, 462 U.S. 810, 820 n.14 (1983) (observing that "rates frequently are in effect too briefly for litigation concerning them to be completed before they are superseded"). That disposes of Consumer Watchdog's suggestion (at 32) that this case is somehow moot. Mercury is subject to regular ratemaking proceedings and, in light of the Court of Appeal's new standard, fully expects to be subjected to rates that would preclude it from earning a fair rate of return in the future.

CONCLUSION

The petition for a writ of certiorari should be granted.

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