

No. 17-537

IN THE
Supreme Court of the United States

MERCURY CASUALTY CO., *ET AL.*,

Petitioners,

v.

DAVE JONES, INSURANCE COMMISSIONER OF THE STATE
OF CALIFORNIA, *ET AL.*,

Respondents.

On Petition for a Writ of Certiorari to the
California Court of Appeal

**BRIEF IN OPPOSITION OF RESPONDENT
CONSUMER WATCHDOG, INC.**

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January 2018

QUESTION PRESENTED

Whether the California Court of Appeal erred in upholding a rate order that allowed a regulated insurance company a substantial rate of return generating an after-tax profit, and that did not impose financial hardship on the company by impairing its financial integrity or ability to operate successfully, as shown by increasing share values and investor dividends, during the brief time when the rates were in effect.

RULE 29.6 STATEMENT

Consumer Watchdog, Inc., is a nonprofit, nonstock corporation. No publicly traded entity has an ownership interest of any kind in it.

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INTRODUCTION

This case involves an intermediate state court's application of garden-variety ratemaking principles to an insurance company's request for a rate increase. Petitioner Mercury Casualty Company (Mercury) is an insurance company operating in California, which, like many states, regulates insurance rates. In 2009, Mercury sought a substantial rate increase for its homeowners insurance line. Applying the ratemaking formula established by regulation, which provided Mercury the opportunity to earn a 7.33% after-tax rate of return on equity, California's Insurance Commissioner found that the company's request would exceed the maximum allowable premium, and that an overall decrease in the company's homeowner policy rates was required. Even with that decrease, the Commissioner determined that Mercury would earn a \$1.8 million after-tax profit on its homeowners insurance line. The decreased rate was in effect for only seven months in 2013, until the Commissioner approved Mercury's request for an 8.26% increase effective December 2013.

Nonetheless, Mercury and the insurance industry trade associations that join it as petitioners here challenged the rate order in the California state courts. They argued, among other things, that Mercury should have been permitted to introduce testimony from an economist that a "fair" rate of return would exceed the 7.33% maximum allowed under California's regulatory formula. Mercury contended that the rate ordered was "confiscatory" in violation of the due process clause because it did not permit the higher rate of return the company wanted. The California Superior Court and California Court of Appeal rejected Mercury's argument, holding that it had not carried

its burden of showing the rate was confiscatory under this Court's decisions, in particular *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). Under *Hope*, determining the reasonableness of rates requires balancing investor and consumer interests, *id.* at 602–05, and a rate is not confiscatory unless it impairs a regulated entity's ability to "operate successfully," *id.* at 605. The California Supreme Court denied Mercury's and the associations' petitions for review.

Mercury now asserts that the intermediate state court's opinion presents an issue on which it claims federal courts of appeals and state supreme courts are divided: whether a state may set regulated rates at levels that "preclude[] a fair rate of return on the regulated entity's capital." Pet. i. The decision below poses no such conflict. The state appellate court applied conventional ratemaking principles, which *incorporate* an administratively determined fair rate of return. In determining whether the resulting rate was confiscatory, the court followed constitutional principles developed by this Court and applied by the federal and state court decisions Mercury cites. Under those principles, a ratemaking system must recognize the regulated industry's interest in a fair rate of return. Individual firms are not guaranteed rates that will earn them a profit, but they receive protections against confiscatory rates that threaten their financial integrity and access to capital. The decision below accords fully with those principles, and their application to the facts here does not merit review.

Mercury's radical submission—that any regulated entity is constitutionally guaranteed the right to substitute a "fair" rate of return specific to it for the rate of return established by duly promulgated regulations generally applicable to the industry—is not supported

by any of the supposedly conflicting decisions Mercury cites. Those decisions reject the view that rates are confiscatory under circumstances comparable to those here. Their outcomes reflect not conflicting legal standards, but the inherently fact-bound nature of ratemaking.

The emptiness of Mercury's argument is underscored by its failure to raise before the California Supreme Court the theory it now asserts. Mercury now argues that the rate approved below violates the Fifth Amendment's Takings Clause (applicable to the states via the Fourteenth Amendment's Due Process Clause). In the state courts, it explicitly *disavowed* a takings argument and rested entirely on substantive due process. It did not base its petition for review on the argument that California case law conflicts with the takings analysis of other jurisdictions, but on the entirely different theory that the leading California decision holding an insurance rate not to be confiscatory under the takings clause, *20th Century Ins. Co. v. Garamendi*, 878 P.2d 566 (Cal. 1994), conflicted with other *California* decisions that Mercury claimed adopted a substantive due process analysis more favorable to its position. Because Mercury did not give the state courts an opportunity to consider the constitutional theory it now advances, its argument is not properly before the Court.

Moreover, there is nothing approaching a "compelling reason[]" (S. Ct. R. 10) for this Court to address an intermediate state court's decision concerning a ratemaking order under which Mercury remained financially strong by any measure during the seven months the rates were in effect. This Court's decision would have no direct practical consequences. The

rates at issue have long since been paid by policyholders, and Mercury cannot dun them for higher premiums if it prevails here. Moreover, in presenting only a “pure question of law” about its claimed constitutional entitlement to a fair rate of return, Mercury wants this Court to ignore that it received the fair rate of return established in the Insurance Commissioner’s regulations—a rate Mercury does not ask this Court to find unfair. Thus, even if the validity of the ratemaking order were a live controversy, Mercury has offered no reason to believe that resolving its “pure question of law” would affect the ultimate outcome.

Examination of the intermediate court’s decision would have no sweeping implications for the national economy or the California insurance industry, which has been highly profitable under the regulatory scheme. This Court should reject the invitation to adopt a standard that would only lead to higher rates for consumers in other cases.

STATEMENT

1. **Proposition 103, *Calfarm*, and *20th Century***

In 1988, California voters enacted Proposition 103, which imposed a temporary rollback and freeze on California property and casualty insurance rates and instituted a permanent system of insurance rate regulation. Proposition 103’s purpose is to “protect consumers from arbitrary insurance rates and practices,” “provide for an accountable Insurance Commissioner,” and “ensure that insurance is fair, available, and affordable for all Californians.” *Donabedian v. Mercury Ins. Co.*, 11 Cal. Rptr. 3d 45, 50 (Cal. Ct. App. 2004) (quoting Prop. 103, § 2). Proposition 103 “replace[d] the former system for regulating insurance rates

(which relied primarily upon competition between insurance companies) with a system in which the commissioner must approve such rates prior to their use.” *Amwest Surety Ins. Co. v. Wilson*, 906 P.2d 1112, 1122 (Cal. 1995). Under the statute, “[n]o rate shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of this chapter.” Cal. Ins. Code § 1861.05(a).

The insurance industry challenged Proposition 103, and the California Supreme Court upheld its key provisions in *Calfarm Ins. Co. v. Deukmejian*, 771 P.2d 1247 (1989). The court held that the statute was facially constitutional because it prohibited “inadequate” rates and, even during the rate freeze, allowed insurers to seek relief against confiscatory rates. *Id.* at 1256–59. The court struck down a provision allowing an insurer to challenge a rate during the temporary freeze only if the insurer was “substantially threatened with insolvency,” which, the court concluded, did not provide adequate protection against confiscatory rates. *Id.* at 1255. The court sustained the remainder of the statute because, with its “prohibition on excessive or inadequate rates,” it “requires rates within that range which can be described as fair and reasonable and prohibits approval or maintenance of confiscatory rates.” *Id.* at 1256–57.

Following *Calfarm*, California’s Insurance Commissioner implemented Proposition 103 by promulgating regulations incorporating the statute’s requirements. See 10 CCR §§ 2641.1–2644.27. The regulations include a ratemaking formula for calculating an insurer’s “maximum permitted earned premium.” 10 CCR § 2644.2. A separate formula is used for calculating the “minimum permitted earned premium.” 10

CCR § 2644.3. The output of the maximum and minimum permitted premium calculations reflects the Commissioner’s determination of the statutory boundaries of “excessive” and “inadequate” rates: Any rate above the maximum permitted earned premium is excessive, and any rate below the minimum permitted premium is inadequate. *See 20th Century*, 878 P.2d at 589.

The regulatory formula includes a profit factor that incorporates a return on equity currently defined as “the risk free rate of return plus 6%.” 10 CCR §§ 2644.15(a) (defining profit factor), 2644.16(a) (defining rate of return). At the time of the ratemaking order at issue here, the rate of return afforded under the regulation was 7.33%. JA 1:190, 1:198.¹ The regulatory formula requires that expenses that are unrelated to the cost of providing insurance and do not benefit policyholders, such as political contributions and lobbying expenses, be excluded from rate calculations. *See* 10 CCR § 2644.10.

The regulations also bar relitigation in individual proceedings of determinations already made on an industry-wide basis under the regulations by providing that “[r]elitigation in a hearing on an individual insurer’s rates of a matter already determined either by these regulations or by a generic determination is out of order and shall not be permitted.” 10 CCR § 2646.4(c).

After the Commissioner’s regulations were promulgated and applied in orders implementing the rate rollback, the industry mounted another constitutional challenge to Proposition 103. The challenge focused on

¹ “JA” refers to the Joint Appendix filed in the court of appeal.

the validity of the regulations and their application to 20th Century Insurance Company, which claimed that the ratemaking formula, as applied to it, yielded confiscatory rates. The California Supreme Court rejected those challenges in *20th Century*, 878 P.2d 566.

20th Century held that the Commissioner's regulations and their application to 20th Century were reasonable and not confiscatory. 878 P.2d at 608–30. The court extensively reviewed this Court's jurisprudence on confiscatory rates, including the seminal opinion in *Hope*, 320 U.S. 591, and its progeny, including *Market Street Railway Co. v. Railroad Commission of California*, 324 U.S. 548, 566 (1945), *In re Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), and the then-recent decision in *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989). See 878 P.2d at 614–18. Those precedents, the court concluded, require that rates be within a zone of reasonableness reflecting a balance between consumers' interests in freedom from excessive rates and regulated firms' interests in maintaining their financial integrity. *Id.* at 615–16.

Quoting *Hope*, *20th Century* recognized that a regulated firm

has a legitimate concern with [its own] financial integrity From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. ... 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. at 615 (quoting *Hope*, 320 U.S. at 603).

At the same time, *20th Century* emphasized that under this Court’s jurisprudence,

the foregoing describes an interest that the producer may pursue and not a right that it can demand. That interest is “only one of the variables in the constitutional calculus of reasonableness.”

Id. (quoting *Permian Basin*, 390 U.S. at 769). Thus, “[a] regulated [firm] has no constitutional right to a profit,” *id.* (quoting *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1180–81 (D.C. Cir. 1987) (en banc)), and, “[i]ndeed, ... no constitutional right even against a loss,” *id.* (citing *Market St.*, 324 U.S. at 564.).

Rates may fall outside the zone of reasonableness, the court concluded, if they do not permit a regulated firm “to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed ... even though they might produce only a meager return.” *Id.* at 616 (quoting *Hope*, 320 U.S. at 605). In other words, as the D.C. Circuit had concluded in *Jersey Central*, 810 F.2d at 1181 n.3, a rate is not confiscatory unless it imposes the kind of “deep financial hardship” that would prevent a regulated firm from operating successfully as described in *Hope*. See *20th Century*, 878 P.2d at 616–17. Because the regulations both on their face and as applied to *20th Century* provided a substantial rate of return that threatened no such financial hardship, the court found no constitutional violation.

This Court received two petitions for certiorari seeking review of *20th Century* and denied both. 513 U.S. 1153.

After *20th Century*, the Insurance Commissioner amended the rate regulations to provide additional safety valves, which now permit insurers to seek “variances” from the regulatory formula on 22 separate grounds. *See* 10 CCR § 2644.27(f)(1)–(9). Those provisions include a “confiscation variance” incorporating the requirement that insurers be permitted to make as-applied challenges to confiscatory rates. *See id.* § 2644.27(f)(9).

2. This Litigation

This case began in 2009, when Mercury sought approval of a 3.9% increase in its homeowners insurance rates. Respondent Consumer Watchdog, an organization whose founder wrote Proposition 103, and which has participated in over 100 rate proceedings under the statute, intervened to oppose the increase and requested a hearing. During the administrative proceedings, Mercury raised its requested increase to 8.8%. Mercury sought to introduce testimony from an economist that the regulatory rate of return (then 7.33%) was inadequate and that a “fair” rate would be higher. Mercury also sought to use calculations for investment income, projected losses, and projected expenses different from those required by the regulatory formula and to recover in its rates “institutional” advertising expenditures excluded by the formula. Mercury argued that these departures from the formula were necessary to avoid a confiscatory rate. It presented no evidence, however, that the rate calculated from the regulatory formula would prevent it from operating

successfully or maintaining its financial integrity under then-existing market conditions.

Following an extensive hearing, the Commissioner excluded Mercury's effort to relitigate the adequacy of the rate of return established by the regulations. He admitted into evidence Mercury's alternative calculations for projected losses, expenses, and investment income, but rejected Mercury's arguments that such evidence was sufficient to prove confiscation. He also rejected Mercury's attempt to recoup the advertising expenditures that the regulatory formula excluded. Applying the regulatory formula, the Commissioner concluded that Mercury's proposed rates were excessive and that an overall rate decrease of approximately 5.4% was required. Even with that decrease, the Commissioner found, the rates would not be confiscatory, and Mercury would earn at least a \$1.8 million after-tax profit on its California homeowners insurance line. JA 1:195.

The reduced rates were in effect for seven months, until December 2013, when the Commissioner approved an overall 8.26% increase in Mercury's homeowners rates (an order Mercury has not challenged). JA 5:1288. Meanwhile, Mercury's financial integrity remained intact by every measure according to its own financial statements: It maintained an A+ credit rating, had a surplus of \$1.065 billion, earned an overall after-tax income of \$226 million (an overall after-tax return of 21%) and paid dividends to its shareholders of \$120 million in 2013. JA 8:2525, 2527.

Mercury sought judicial review of the Insurance Commissioner's rate order, challenging both the exclusion of its advertising expenses and the determination that it was not entitled to a higher rate of return

than the ratemaking formula allowed. When both Mercury’s arguments were rejected by the California Superior Court, Mercury appealed.

The California Court of Appeal affirmed. Much of its opinion addressed Mercury’s arguments, and those of its supporting insurance industry trade group intervenors, that the exclusion of its advertising revenues was improper under the statute and regulations and even (in the view of the trade groups) unconstitutional under the First Amendment—arguments petitioners no longer advance.

The Court of Appeal also addressed Mercury’s claim that the rate order was confiscatory because it allegedly did not allow the “fair” rate of return Mercury sought using its alternative rate calculations. The appellate court reviewed the California Supreme Court’s opinion in *20th Century* and the decisions of this Court on which it rested, and applied their teaching that a regulated entity’s legitimate interest in the opportunity for a fair rate of return must be balanced against consumer interests. Consistent with *Hope*’s balancing approach, the Court of Appeal concluded that the regulated entity must demonstrate inability to operate successfully as a necessary condition of confiscation. Pet. App. 37a. The court found that Mercury had shown no such hardship from application of the regulatory rate formula. *Id.* at 41a. Further, it held that Mercury’s argument that a higher rate of return would be more “fair” not only did not support a constitutional claim, but was prohibited by the relitigation ban on challenges to determinations already made by the Commissioner in promulgating regulations—here, the regulation establishing the risk-free-rate-of-return-plus-6% standard. *Id.* at 43a–44a.

Mercury and the industry trade groups that join its petition here filed separate petitions for review in the California Supreme Court. The petitions repeated the arguments about Mercury’s advertising expenditures. They also argued that the California Supreme Court should resolve what they characterized as an inconsistency between *Calfarm*’s invalidation of Proposition 103’s “insolvency” standard and *20th Century*’s holding that a rate may be confiscatory only if it threatens financial harm to a regulated entity. Stressing that Mercury was raising “only a due process claim” and not a takings challenge to the rate order, Mercury Pet. for Review 21, the petitions proposed that the California court “reconcile” its decisions by holding that substantive due process imposes more stringent limits on rates than does takings jurisprudence, and they argued that takings cases (including the kinds of cases they rely on now) were irrelevant to their claim. *See id.* at 21–23. Nowhere did they mention the federal appellate and state supreme court decisions on which they now rely, other than *Jersey Central*, which they described as unclear but beside the point because it addressed a takings claim, not their proposed due process approach. *See id.* at 21–22; Personal Ins. Fed’n of Calif. Pet. for Review 15–16.

The California Supreme Court denied review.

REASONS FOR DENYING THE WRIT

I. The lower court’s opinion applies settled principles of this Court’s jurisprudence to the facts of this case.

Mercury contends that the California Court of Appeal broke new ground by “explicitly den[ying] that a ‘fair rate of return’ had any place in the constitutional analysis” of a ratemaking order, Pet. 8 (citing Pet.

App. 38a), and it asserts that the case presents the question whether a state ratemaking order may “preclude” a fair rate of return, *id.* at i. The state court, however, did not hold that a fair rate of return has no place in the constitutional analysis, nor did the rate order preclude Mercury from obtaining a fair rate of return. Mercury’s question is thus not presented by this case.

Rather, applying *20th Century’s* analysis of this Court’s opinions, the court of appeal held that a regulatory ratemaking system must consider the interest in a “return to the equity owner ... commensurate with returns on investment in other enterprises with corresponding risks.” Pet. App. 34a (citation omitted). The court recognized, however, that the investor interest must be balanced against the interest of consumers in not paying exploitative rates. *Id.* Such balancing results in a “broad zone” in which rates are reasonable, not a rigid requirement that rates be set at any “particular point.” *Id.* at 35a. A rate does not fall below the zone of reasonableness and threaten confiscation unless it does not allow a regulated firm to “operate successfully,” by, for example, impairing its “financial integrity,” including its ability to “maintain credit and attract capital.” *Id.* at 35a–36a. In other words, a rate may be confiscatory only if it causes “deep financial hardship”—a phrase from Judge Bork’s summary in *Jersey Central*, 810 F.2d at 1181 n.3, of *Hope* and this Court’s other ratemaking decisions. Pet. App. 35a–38a.

In light of the state court’s analysis, the only federal question that could be presented here is whether applying this Court’s own *Hope* standard violates the

Constitution.² The court of appeal’s discussion of the burden required to demonstrate that a rate is unconstitutionally confiscatory accords fully with this Court’s leading precedents. The Court articulated the relevant principles most thoroughly in *Hope*, in holding that the inquiry in any ratemaking proceeding is whether the “total effect of the rate order” is “unjust and unreasonable in its consequences.” 320 U.S. at 602. That determination, *Hope* held, “involves a balancing of the investor and the consumer interests.” *Id.* The “investor interest,” the Court stated, “has a legitimate concern with the financial integrity of the company whose rates are being regulated,” including the need for revenues to cover capital costs, and returns on equity commensurate with those of businesses facing similar 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 603.

The investor interest, however, is only half of the equation: The consumer interest in being free of “exploitation” from excessive rates must also be considered. *Id.* at 612. Under the appropriate balancing approach, no particular rate of return is required. “Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on the so-called ‘fair value’ rate base.” *Id.* at 605. Indeed, *Hope* emphasized that a rate order applicable to a specific service offered by a firm need not even “insure that the

² As discussed below, at 28–30, in the state courts, Mercury disclaimed the constitutional theory it now seeks to advance. Thus, even this question is not properly before the Court.

business shall produce net revenues.” *Id.* at 603 (quoting *FPC v. Natural Gas Pipeline Co. of Am.*, 315 U.S. 575, 590 (1942)); accord, e.g., *Market St.*, 324 U.S. at 566 (“regulation does not assure that the regulated business make a profit”).

Hope’s holding, and that of *Natural Gas Pipeline* two years earlier, reflected a definitive rejection of the *Lochner*-era approach of *Smyth v. Ames*, 169 U.S. 466 (1898), under which the Constitution was thought to demand that regulated rates rigidly reflect a rate of return applied to the fair value of the regulated entity. See *Natural Gas Pipeline*, 315 U.S. at 602 (Black, J., concurring). *Hope*’s balancing test has provided the framework for assessing the constitutionality of rate-making orders ever since. See *Verizon Commc’ns, Inc. v. FCC*, 535 U.S. 467, 483–84 (2002).

This Court broadly reiterated *Hope*’s principles in *Permian Basin*, 390 U.S. 747. There, the Court emphasized the “heavy burden” of showing that a rate is confiscatory. *Id.* at 767 (quoting *Hope*, 320 U.S. at 602). The Court stressed that the Constitution does not require “any particular rate level,” *id.*, but only that rates fall within a “zone of reasonableness,” *id.* (quoting *Natural Gas Pipeline*, 315 U.S. at 585). The Court repeated that ratemaking involves a “balance” of consumer and investor interests, *id.* at 770, 792, such that a rate order “may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable.” *Id.* at 792.

Thus, *Permian Basin* held, “investors’ interests provide only one of the variables in the constitutional

calculus of reasonableness.” *Id.* at 769. Accordingly, “[r]egulation may, consistently with the Constitution, limit stringently the return recovered on investment.” *Id.* Moreover, regulators may make determinations of fairness “for a regulated class without first evaluating the separate financial position of each member of the class,” *id.* at 769, even though the resulting rates provide different returns to firms with different costs and capital structures, *id.* If the regulator “takes fully into account the various interests” it is “required ... to reconcile,” “there can be no constitutional objection.” *Id.* at 770.

This Court again recognized the vitality of these principles in *Duquesne Light*, 488 U.S. 299. The Court reaffirmed that *Hope* remains the “landmark” statement of the constitutional standards applicable to ratemaking, *id.* at 310, and that a rate is “not constitutionally objectionable” if it does not “jeopardize the financial integrity of the companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital,” *id.* at 312. The Court rejected any suggestion that the allowed rate of return is the exclusive determinant of whether a rate is confiscatory. Rather, the legitimacy of any rate will depend only “to some extent on what is a fair rate of return,” *id.* at 310, and the rate of return is just “one of the elements” relevant to ratemaking, *id.* at 314. Thus, the rate-of-return issue is not itself constitutional, but only has “constitutional overtones.” *Id.* at 310. *See also Verizon*, 535 U.S. at 524 (upholding a ratemaking statute that required that rates be set without reference to a rate of return, and characterizing a “confiscatory” rate as one that threatens a regulated firm’s “financial integrity”).

Both the California Supreme Court's opinion in *20th Century*, which this Court declined to review 23 years ago, and the California Court of Appeal's decision in this case conscientiously follow the governing principles from this Court's case law. Those principles are flatly inconsistent with Mercury's view that the calculation of a specific "fair" rate of return that a regulated firm is guaranteed determines whether a rate is confiscatory: The Court's cases make clear that the interest in a rate of return is "only one of the variables" involved, *Permian Basin*, 390 U.S. at 769; *Duquesne Light*, 488 U.S. at 314, and that a ratemaking proceeding may strike a permissible balance for a firm even if the firm suffers a *net loss* during the period of the rate. *Hope*, 320 U.S. at 603. The decisions are likewise incompatible with Mercury's assertion that a firm is entitled to a rate of return computed specifically for it where, as here, the regulator has already made a class-wide determination of the fair rate of return and allowed the firm the opportunity to obtain that return. *Permian Basin*, 390 U.S. at 769. Collectively, this Court's decisions validate the California courts' view that whether a rate is confiscatory depends not on whether its rate of return meets some specific level of fairness, but on whether it permits the regulated firm to operate successfully and avoid financial hardship.

Mercury does not contend that anything in this Court's jurisprudence has changed since the California Supreme Court canvassed the case law in deciding *20th Century*. The most recent ratemaking decision of this Court cited by Mercury is *Duquesne Light*, which was faithfully followed in *20th Century* and the decision below. Mercury does not even contend that *Duquesne Light* changed the law: It concedes that *Hope*

and *Permian Basin* remain definitive statements of the principles that determine whether a rate is constitutionally insufficient. Pet. 17. The California Court of Appeal's articulation of these long-settled principles more than two decades after *20th Century* offers no reason for review.

Moreover, Mercury does not, and cannot, assert that the *application* of these principles to the facts here presents grounds for review by this Court. The purported "misapplication of a properly stated rule of law" is not generally a basis for granting a petition for certiorari. S. Ct. R. 10. Any argument that the rates here were confiscatory under the proper standard would be fanciful in any event. The rate formula included a 7.33% rate of return on equity, the rate order gave Mercury an estimated \$1.8 million after-tax profit on homeowners insurance policies, and the rates were in force for only seven months before they were substantially increased. Mercury does not contend that the rate impaired its financial integrity, cut off its access to capital or ability to pay dividends, prevented it from operating successfully, or caused it any financial hardship.

II. There is no conflict among federal appellate and state supreme courts on the question presented.

The clarity with which this Court's decisions support the California courts' approach is not, as Mercury asserts, obscured by disagreement with that approach by federal appellate courts or other state supreme courts. The decision below does not conflict with the decisions Mercury cites.

Mercury cites no decision holding that a rate order allowing a rate of return and after-tax profit comparable to those at issue here even came close to the constitutional line. Nor can Mercury point to any decision holding that a rate of return determined by a regulator to be fair in a duly promulgated regulation applicable to a class of businesses can be deemed confiscatory merely because a particular firm that is able to operate successfully under the regulatory formula advocates calculation of a different rate of return specially for itself, or the use of alternative methodologies for projecting losses, expenses, and investment income not allowed under the regulatory formula.

Moreover, none of the cases Mercury cites considers and rejects the standard articulated in *20th Century* and applied below, under which a rate may be confiscatory only if it imposes financial hardship on a firm by preventing it from operating successfully. The absence of such authority is glaring given the decades that have passed since this Court articulated the governing principles in *Hope*, and since both the D.C. Circuit and the California Supreme Court applied the “deep financial hardship” standard in *Jersey Central* and *20th Century*, respectively. If other courts disagree with that standard as fundamentally as Mercury contends they do, they have not said so. Review of the supposedly conflicting decisions Mercury cites reveals the reason for that silence: The courts do not disagree.

A. Mercury’s federal citations evince no conflict.

Mercury’s assertion that the D.C., Sixth, and Ninth Circuits have adopted standards incompatible

with that applied below rests entirely on three decisions that are fully consistent with both the decision below and *20th Century*.

As to the D.C. Circuit, Mercury cites *Jersey Central*, the decision that was the source of the “deep financial hardship” summary of *Hope*’s teachings invoked by the court below and by *20th Century*. Mercury’s counterintuitive assertion that the California courts’ decisions conflict with the very decision whose analysis they endorsed rests on its claim that Judge Bork’s use of the phrase must be read in context to mean that there is “deep financial hardship” whenever a firm receives less than its desired rate of return. Pet 12.

Jersey Central’s context indicates just the opposite. Not only did the D.C. Circuit cite the same passages from *Hope* relied on in *20th Century* and the decision below, see 810 F.2d at 1175–78, but the opinion repeatedly emphasized that the rate at issue left the regulated utility in “serious financial difficulty” because it “lack[ed] ... access to long-term capital” and had “precarious[] ... short-term credit.” *Id.* at 1171. The court held that the utility was entitled to a hearing on whether the rate was confiscatory precisely because these allegations “track[ed] the standards of *Hope* and *Permian Basin* exactly” by evidencing severe strains on the company’s “financial integrity.” *Id.* at 1178. Judge Starr, whose vote was essential to the outcome, likewise explained that the reason the utility had a claim that the rate was confiscatory was that it was “perilously close to the edge of bankruptcy, unable to secure long-term credit, and unable to attract capital to the enterprise,” and that there was “no prospect” that its investors would “earn a return on their investment.” *Id.* at 1193 (Starr, J., concurring).

The stated reason the majority included the footnote concerning “deep financial hardship” was to emphasize that these circumstances were critical to its holding and to “explicitly reject the dissent’s contention that under our holding ‘the investor is guaranteed a return on his investment, if prudent when made.’” *Id.* at 1182 n.3. Those were the reasons the court stressed that “the only circumstance under which there is a possibility of a taking of investors’ property by virtue of rate regulations is when a utility is in the sort of financial difficulty described in [*Hope*].” *Id.* And “even where [that] sort of deep financial hardship ... is present, the utility ... is not entitled to any greater return on its investments unless it shows at the hearing both that the rate was unreasonable and that a higher return would not exploit consumers.” *Id.* In short, the court referred to “deep financial hardship” precisely to explain that it was not adopting the guaranteed-return standard Mercury advocates here.

The Sixth Circuit’s opinion in *Michigan Bell Telephone Co. v. Engler*, 257 F.3d 587 (2001), likewise reveals no conflict. *Engler* granted a preliminary injunction based on the likelihood that a statute that froze telephone rates was unconstitutional because it did not provide a *mechanism* to challenge rates as confiscatory. *See id.* at 593–94. Moreover, although the statute purportedly required just and reasonable rates, its definition of such rates did not allow *any* return on investment, but only recovery of *costs*. *See id.* at 594. *Engler’s* statement that the Constitution requires a ratemaking scheme to allow for *some* rate of return to be “constitutionally adequate,” *id.*, does not speak to the standard for determining whether a rate that *allows* a return on investment is confiscatory, much less

conflict with the holding below that any such determination requires consideration of whether the rate imposes financial hardship on the regulated firm.

Finally, Mercury's assertion that California's case law conflicts with the Ninth Circuit's holding in *Guaranty National Insurance Co. v. Gates*, 916 F.2d 508 (1990), is also erroneous. The Ninth Circuit's holding in that case, that a Nevada insurance ratemaking law was unconstitutional because it allowed an increase in rates only where an insurance company could show that it was "substantially threatened with insolvency," followed the California Supreme Court's holding to exactly that same effect in *Calfarm*, which the later *20th Century* decision left intact.

Gates also held that the Nevada law could not be salvaged by its provision allowing challenges to "inadequate" rates because the law defined an "inadequate" rate as one that failed to cover an insurance company's losses and expenses, and thus provided no margin for any return on equity. 916 F.2d at 515. *Gates*'s condemnation of a law that precludes a return on equity altogether is perfectly consistent with *20th Century* and the decision below, which hold that a ratemaking law must recognize a regulated entity's interest in pursuing a rate of return. Nothing in *Gates* holds that where, as here, a ratemaking formula takes into account the interest in a fair rate of return and provides the regulated entity a substantial profit, the financial hardship criterion derived from *Hope* is an improper basis for assessing any claim that the resulting rate is confiscatory.

Mercury asserts that the "conflict" between the California case law and *Gates* is "particularly untenable" because California is in the Ninth Circuit and

thus, “in California, regulated firms are entitled to a fair rate of return in the federal courthouse but will be denied the same right in the state courthouse down the street.” Pet. 15–16. But Mercury cites no instances, in the 23 years since *20th Century*, of any inconsistent decisions rendered by state and federal courts in California over confiscatory-rate claims. Indeed, Mercury points to no examples of federal courts criticizing or disagreeing with *20th Century*’s standard. The absence of such cases tellingly indicates that the “conflict” is not real.

B. State supreme courts are not in conflict.

Mercury’s claim that state supreme courts deeply disagree over the standards applicable to confiscatory-rate claims is likewise not credible. The holdings of the cases Mercury cites are fully consistent with the decision below.

The two recent cases Mercury cites to illustrate its claimed conflict instead strikingly demonstrate fundamental *agreement* among the state courts. In *Fitchburg Gas & Electric Light Co. v. Department of Public Utilities*, the Supreme Judicial Court of Massachusetts *rejected* the claim that a statute prohibiting electric utilities from recovering assessments for a storm trust fund from ratepayers was unconstitutionally confiscatory. 7 N.E.3d 1045 (2014). The court stated that regulators must allow regulated entities the “*opportunity* to realize a fair and reasonable return on [their] investment,” *id.* at 154 (emphasis added), not that they must *guarantee* such returns—a view fully consistent with that taken by the courts in this case and in *20th Century*. A determination that the statute resulted in confiscatory rates, the court went on, could only be made if a rate order failed to produce rates

“adequate to preserve investor confidence and cover legitimate expenses.” *Id.* at 1057. The court observed that a rate order would “likely go too far” if it “defeat[ed] the incentive to invest in the public utility and render[ed] the operation of the company financially infeasible,” *id.* at 1057 n.18—a standard indistinguishable from that applied below.

Mercury’s reliance on *Anthem Health Plans of Maine, Inc. v. Superintendent of Insurance*, 40 A.3d 380 (Me. 2012), the other relatively recent decision it invokes, is equally inexplicable, as the Maine Supreme Judicial Court’s reasoning in *Anthem* was strikingly similar to that of the California Court of Appeal here. *Anthem* upheld an insurance rate order that allowed the insurer a “risk and profit margin” of only 1% and specifically rejected the insurer’s claim that the rate eliminated the company’s “opportunity to earn a reasonable profit.” *Id.* at 381.

The court upheld the state Superintendent of Insurance’s determination that the rate was not inadequate because “[t]he Superintendent’s interpretation of ‘inadequate’ as a standard that protects an insurer’s ‘financial integrity’ comports with the majority of other jurisdictions that define an ‘inadequate’ rate as one that either threatens an insurer’s solvency or would tend to destroy competition or create a monopoly, or as a rate that is insufficient to cover an insurer’s anticipated costs and obligations in providing a particular class of insurance.” *Id.* at 384. Because the court found no such adverse effects on the company’s financial integrity, it rejected the company’s argument that it was entitled to a larger increase to provide a “fair and reasonable rate of return” providing a “profit margin consistent with the industry-wide aver-

age.” *Id.* The court said that the company must be permitted an “opportunity” for a reasonable return, but held that the company could not show it had been deprived of that opportunity when the rate order allowed it to earn a profit. *Id.* at 389. In short, the court applied reasoning fully consistent with that of the court below to uphold a *less* generous rate order.

The grab-bag of older cases Mercury cites from a handful of other jurisdictions are no more supportive of its claim of conflict. Mercury’s leading example, *State Farm Mutual Automobile Insurance Co. v. New Jersey*, 590 A.2d 191, 199 (N.J. 1991), is a particularly weak reed on which to hang a claim of conflict. There, the court *rejected* a claim that a rate statute that prevented insurers from passing certain surcharges and assessments through to policyholders was confiscatory.

The insurers contended that the statute would force them to operate at a loss, in violation of their claimed entitlement to a fair rate of return. The court cited *Hope* for the proposition that a fair rate of return is one consideration implicated in determining the constitutionality of ratemaking, but immediately added that “the constitutional requirement that a business be permitted a return sufficient to assure its financial health does not necessarily require any particular level of profit above what is adequate to attract and retain invested capital.” *Id.* at 199. Citing *Permian Basin*, the court stated that investor interests are “only one of the variables in the constitutional calculus,” and that regulators may “limit stringently the return recovered on investment.” *Id.* (quoting 390 U.S. at 769). And it endorsed the proposition, central to the decision below and to the *20th Century* decision, that

Hope requires balancing of investor and consumer interests. *Id.* Ultimately, the court held the statute constitutional because it did not prevent state regulators from allowing rates sufficient to preserve the financial health of insurers. *See id.* at 206–07. Nothing in that determination conflicts with the decision below, and the constitutional principles the court articulated agree completely with those announced by the California courts in this case and *20th Century*.

The remaining decisions Mercury cites are similarly unhelpful to its position. In *Peoples Natural Gas Co. v. City of Bellevue*, the Nebraska Supreme Court rejected a claim that a gas company’s rates reflected a confiscatory rate of return. 579 N.W.2d 510 (1998). The court held, consistent with the decision below, that a rate is constitutionally adequate if it is “reasonably sufficient to assure confidence in the financial soundness of the utility” and allows the company “to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.” *Id.* at 512 (citation omitted).

In *Stewart v. Utah Public Service Commission*, the Utah Supreme Court’s holding was that a utility could not be allowed a *higher-than-reasonable* rate of return to induce it to make discretionary investments in the state. 885 P.2d 759, 770–74 (1994). The court briefly touched on the *Hope* balancing approach and the need for a rate of return assuring the utility’s financial soundness. But it was not called on to determine the standard for when a rate is confiscatory, and nothing in its holding is inconsistent with the holding below that a rate may be confiscatory only if it harms a regulated entity’s financial integrity.

Finally, in *In re Petition of PNM Gas Services*, the New Mexico Supreme Court's holding did not concern the requisites of a reasonable rate of return; it addressed whether certain prudently incurred debts and expenses were properly included in a utility's rate base. 1 P.3d 383 (2000). The court's brief discussion of constitutional principles and its passing observation that "[a] reasonable rate of return is one that provides a fair opportunity for the utility to receive just compensation for its investments ... and that ... enabl[es] the utility 'to attract new capital to maintain, improve, and expand its services in response to consumer demand,'" *id.* at 391, are fully consistent with the California courts' view that confiscation analysis requires determination of whether a rate harms the regulated firm's financial soundness.

By contrast with its inaccurate claims of conflict, Mercury's acknowledgment that other state court decisions are unambiguously consistent with the ruling below (and *20th Century*) is correct as far as it goes. But Mercury's assertion that these decisions reflect an incorrect minority view fails to acknowledge that two of them, *Pennsylvania Electric Co. v. Pennsylvania Public Utility Commission*, 502 A.2d 130, 131 (Pa. 1985), and *Kansas Gas & Electric Co. v. State Corporation Commission*, 720 P.2d 1063, 1071 (Kan. 1986), were appealed to this Court under its former mandatory jurisdiction over state supreme court decisions holding state statutes constitutional, and the appeals were dismissed for want of a substantial federal question. *See Metro. Ed. Co. v. Pa. Pub. Util. Comm'n*, 476 U.S. 1137 (1986); *Kan. Gas & Elec. Co. v. State Corp.*

Comm'n, 481 U.S. 1044 (1987).³ Such a dismissal was a precedential, merits determination equivalent to summary affirmance by this Court. *Hicks v. Miranda*, 422 U.S. 332, 344 (1975).

Mercury's assertion that these decisions conflict with decisions of other states including New Jersey also overlooks that *Pennsylvania Electric* followed a substantially similar ruling by the New Jersey courts, which was likewise summarily approved by this Court on appeal. See *Jersey Cent. Power & Light Co. v. Bd. of Pub. Utils.*, 466 U.S. 947 (1984). The Kansas, Pennsylvania and New Jersey decisions, moreover, correctly anticipated *Duquesne Light's* holding that it was not confiscatory to exclude from a utility's rates prudently incurred costs associated with certain nuclear plants.

In sum, Mercury cites no genuine support for its contention that the financial hardship standard applied below implicates a conflict among federal appellate and state supreme courts. Absent such a conflict, and in light of the clear grounding of the California courts' approach in this Court's longstanding decisions, there is no need for review by this Court.

III. Mercury did not present its current arguments to the California Supreme Court.

That Mercury's arguments fly in the face of this Court's holdings and invoke a nonexistent lower-court conflict is reason enough to deny review. Mercury's failure to present its current arguments to the California Supreme Court underscores that this Court should deny review.

³ As to one of the questions presented in *Kansas Gas*, the Court dismissed the appeal as moot.

This Court decides only questions of federal law that were presented to and/or actually decided by state courts. *See Heath v. Alabama*, 474 U.S. 82, 87 (1985). Thus, when a petitioner seeks review of an intermediate state appellate court’s decision following a state supreme court’s denial of discretionary review, the federal question presented to this Court must have been included in the petition for review submitted to the state supreme court.

Here, Mercury asks this Court to decide that the intermediate state court’s decision stated an incorrect standard for determining when a ratemaking order effects an unconstitutional taking. *See* Pet. i, 2. But in the state appellate court, petitioners disavowed a takings claim, and contended that the challenge to the rate order sounded in due process and was therefore not subject to *20th Century*’s takings analysis. *See* Pet. App. 38a–40a. The petitions for review in the California Supreme Court similarly contended that Mercury had exclusively advanced a due process argument, and that takings decisions (including *Jersey Central*, on which Mercury now purports to rely) were irrelevant. *See* Mercury Pet. for Review 21–22. Mercury’s central argument for review was that the California Supreme Court’s holding in *20th Century* conflicted with its earlier *Calfarm* ruling (and other California decisions involving rent-control ordinances), and that the state supreme court should resolve the conflict by clarifying that *Calfarm* rested on a due process theory that imposed more stringent limits on ratemaking than *20th Century*’s takings analysis. *See id.* at 21–23.

Having failed to persuade the California Supreme Court that it should “reconcile” *Calfarm* and *20th Century* by creating a new substantive due process doctrine to limit state ratemaking authority, Mercury

now changes its tune and embraces the takings arguments it formerly disclaimed. As explained above, those meritless arguments present no need for review by this Court. Even if that were not the case, however, Mercury's failure to give the state courts a chance to consider them would preclude review. This Court should not reward Mercury's bait-and-switch tactics.

IV. Mercury's assertions that this case merits review are insubstantial.

Mercury contends that issues concerning confiscatory insurance rates are recurring and important enough to demand this Court's attention. However, although challenges to ratemaking decisions often include claims that rates are unconstitutionally confiscatory, that point alone does not suggest a need for review. The fundamental principles governing such cases were long ago established by this Court and have been stated repeatedly in the decades since *Hope*. Under those principles, meritorious claims that rates are confiscatory are rare—as the cases Mercury itself cites demonstrate. Mercury offers no reason to think that the lower courts are not capably dealing with the few cases where rate orders truly injure regulated firms or that they otherwise need further guidance from this Court.

This case is surely not one where there is reason to suspect an injustice. The rate order allowed Mercury a significant rate of return on equity and an after-tax profit on its homeowners insurance line, and it did no apparent damage to the thriving company in the few short months when it was in effect. Mercury ranked eighth among California homeowners insurers in market share, and was able to achieve an overall after-tax income of \$226 million (an after-tax return of 21%),

maintain its A+ credit rating and a surplus of \$1.065 billion, and pay \$120 million in shareholder dividends in 2013. JA 8:2525, 2527. In such circumstances, an intermediate state-court opinion rejecting a claim of confiscation hardly merits this Court's review.

Nor is review necessary to prevent damage to California's insurance industry or the national economy. The industry has remained highly profitable under regulated rates. According to the National Association of Insurance Commissioners' Report on Profitability by Line by State in 2012 (2013), California insurers averaged an 18.1% return on net worth for the homeowners line, and 10.7% for all lines combined, from 2003 to 2012. JA 8:2519-21.

This case also provides no occasion for considering whether the requirement that a regulated firm show financial hardship to "the enterprise as a whole" to challenge an allegedly confiscatory rate could improperly "force national insurers to use money earned in other States to support policies sold in California, effectively compelling ratepayers in other States to subsidize the California insurance market." Pet. 23. The court of appeal did not address such subsidization, and stated only that it was not allowing the commissioner to exercise power over rates outside the state. Pet. App. 42a. The trade associations' petition for review below therefore acknowledged that the issue was not clearly presented by the court's opinion. *See* Personal Insurance Fed'n of Calif. Pet for Review, at 3. And this case is particularly unsuitable for addressing such arguments because California accounted for nearly 80% of Mercury Casualty's premiums in 2013. *See* Cal. Dept. of Ins., Report of Examination of the Mercury Casualty Company as of December 31, 2013, at 10, <https://www.insurance.ca.gov/0250-insurers/>

0300-insurers/0400-reports-examination/upload/MercuryCasualtyCo13.pdf. Any suggestion that the company's success resulted from out-of-state policyholders subsidizing confiscatory California rates is highly improbable.

Review of this case is particularly unwarranted because it is unclear what such review would accomplish at this point. The rates at issue have not been in effect for four years. A ruling by this Court that Mercury should have been permitted to present evidence that a "fair" rate of return would be higher than that allowed under the regulatory formula would require additional administrative and state-court proceedings likely to last years more over an issue of no ongoing practical significance. Regardless of the outcome, Mercury would not recoup additional monies from policyholders who paid it the approved rates four years ago. Indeed, from an Article III standpoint, the case may well be moot: It presents no live controversy over any form of relief sought by Mercury in this case.⁴ The California courts may entertain such proceedings without regard to Article III, but this Court may not. *See, e.g., Kan. Gas*, 481 U.S. 1044 (dismissing part of challenge to state-court ratemaking decision that had become

⁴ In the California Superior Court, Mercury argued that the case was not moot under California justiciability principles because its arguments might support a future claim against the state for just compensation for a taking. But, as explained above, Mercury disavowed a takings claim in the California Court of Appeal and the California Supreme Court, and thus forfeited any constitutional entitlement to just compensation. Mercury also suggested in the state trial court that resolution of this case might provide a basis for some relief in future administrative proceedings, but that speculative possibility is an insubstantial basis for finding a live controversy under Article III. *See Camreta v. Greene*, 563 U.S. 692, 711–12 (2011).

moot). Even if the case is not technically moot, perpetuating litigation over rates now years in the past is a poor use of this Court's resources.

In any event, Mercury has made no showing that acceptance of its view that it is constitutionally guaranteed a fair rate of return would change the outcome of this case. Mercury was afforded the fair rate of return established by the Insurance Commissioner in promulgating the ratemaking formula. Even if Mercury were entitled to collaterally challenge those rules in this case—which it is not, under the rules barring “relitigation” of issues already decided in rulemaking proceedings, *see supra* p. 6—Mercury's petition does not argue that the rate of return allowed was unfair, let alone explain why. Because Mercury received a fair rate of return, a decision on Mercury's “pure question of law” would be nothing more than an advisory opinion on an abstract proposition. This Court does not sit to provide such opinions. *See, e.g., Golden v. Zwickler*, 394 U.S. 103, 107 (1969).

Finally, although there is no need for review, acceptance of Mercury's claims would have extremely important, negative consequences for California consumers in the form of higher insurance premiums. Mercury's ultimate premise is that a “fair” rate of return would be one comparable to what it would earn in an unregulated market. But the excessive rates charged and excessive profits earned by insurance companies in the unregulated market were what prompted California voters to enact Proposition 103 to regulate insurance rates. Allowing insurers to substitute their preferred notion of a “fair” rate of return in every rate proceeding for the rates of return established by California's insurance regulators—rates under which the California insurance market remains

thriving and profitable—would thwart the purposes of regulation by requiring the regulated market to replicate the failures of the unregulated one that preceded it.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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January 2018