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SUPERIOR COURT OF THE STATE OF CALIFORNIA

FOR THE COUNTY OF SACRAMENTO

MERCURY CASUALTY COMPANY, Petitioner and Plaintiff. vs. DAVE JONES, IN HIS OFFICIAL CAPACITY AS THE INSURANCE COMMISSIONER OF THE STATE OF CALIFORNIA, Respondent and Defendant,	CASE NO.: **VERIFIED PETITION FOR A PEREMPTORY WRIT OF MANDATE UNDER CCP § 1094.5, GOV'T CODE § 11523, AND INSURANCE CODE § 1858.6; AND COMPLAINT FOR DECLARATORY RELIEF AND INJUNCTIVE RELIEF** **[STAY REQUESTED]**

BY FAX

Petitioner and Plaintiff Mercury Casualty Company ("Mercury Casualty") alleges as follows:

INTRODUCTION

1. Mercury Casualty petitions this Court for a peremptory writ of mandate under Code of Civil Procedure section 1094.5 directed to Respondent and Defendant Dave Jones, in his capacity as California Insurance Commissioner ("Commissioner"), seeking judicial review and an order vacating the Commissioner's February 11, 2013 Order Adopting Proposed Decision

("Commissioner's Order") in *In the Matter of the Rate Application of Mercury Casualty Company,* File No. PA-2009-00009 (hereinafter "Rate Proceeding"). A true and correct copy of the February 11, 2013 Order is attached hereto as Exhibit "A" (hereinafter "Commissioner's Order or Order").

2. Even though Mercury Casualty's homeowners premiums are among the lowest in the state, the Commissioner, based on outdated data, adopted the ALJ's decision that Mercury Casualty's rates for its homeowners' lines of insurance overall must be decreased even further by approximately 5%.

3. The Order separates the rates to be implemented by coverage forms. The Rate Proceeding involved three homeowners insurance coverage forms, the HO-3, HO-4 and HO-6 forms. HO-3 is the more standard homeowners insurance coverage form. HO-4 provides renters and tenants coverage. HO-6 provides condominium owners coverage. For HO-3, which is the largest portion of Mercury Casualty's homeowners line of business, the Order states the rates should be decreased by 8.18%. For HO-4, which is a much smaller segment of the homeowners line, the Order imposes a 4.32% increase. For HO-6, which is also a smaller segment of the homeowners line, the Order imposes a 29.44% increase. When the overall premium volume is taken into account for these different coverage forms, the overall rate decrease is approximately 5%.

4. The Commissioner reached his erroneous conclusions and rate decrease notwithstanding the fact that his own agency, the California Department of Insurance ("CDI"), advocated in the Rate Proceeding that the rate should be decreased overall by 2.33%. By coverages, the CDI argued for -2.21% for HO, -13.81% for HO-4, and 1.88% for HO-6. Mercury maintained that it was entitled to an 8.8% increase overall if allowed the 90% concentration variance under 10 Cal. Code Regs. ("C.C.R.) § 2644.27(f)(3) and, alternatively, a 6.9% increase without the concentration variance.[1] The Commissioner's Order rejected both the CDI's and Mercury's recommended rate changes. Instead, the Commissioner's Order adopted the ALJ's own actuarial calculations which she performed independently from the parties.

5. Pursuant to Insurance Code section 1858.6, "the court is authorized and directed to

[1] Mercury's breakdown by coverage form is as follows if the concentration variance is granted: 7.3 for HO-3; 5.5% for HO-4; and 31.2% for HO-6. If the concentration variance is not applied, the rate changes are 5.5% for HO-4; 4.2% for HO-4; and 29.0% for HO-6.

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exercise its independent judgment on the evidence and unless the weight of the evidence supports the findings, determination, rule, ruling or order of the commissioner, the same shall be annulled."

6. This Order should be "annulled" as it is in violation of law, not supported by the findings, and the findings are not supported by the weight of the evidence, in that:

- The Order is not based upon the most updated data that was available during the course of the administrative hearing though the use of such data is expressly required under the Regulations and such updated data shows a worsening loss experience that supports Mercury Casualty's need for a rate *increase*, not a decrease.
- The Order is based upon a number of incorrect legal and factual conclusions concerning the meaning, applicability, and calculation of the "institutional advertising" excluded expense component of the rate regulations.
- The Order is based upon an incorrect conclusion concerning the applicability of the "political contributions and lobbying expenses" for purposes of determining excluded expenses under the rate regulations because it incorrectly treated, as excluded expenses, the political and lobbying expenses of companies *other than Mercury Casualty Company*.
- The Order is based upon a number of incorrect legal and factual conclusions concerning the meaning and applicability of the "constitutional" (i.e., confiscation) variance under the rate regulations, including the erroneous determination that Mercury is not entitled the opportunity to earn a fair rate of return on the rates it charges its policyholders;
- The Order is based on the improper exclusion of evidence and the consideration of information not introduced into evidence during the Rate Proceeding;
- The Order is based upon an incorrect determination that Mercury Casualty did not qualify for a leverage variance under 10 C.C.R. § 2644.27(f)(3), though more than 90% of its homeowners' line of business is located in California.

7. Mercury Casualty also seeks a declaration regarding the interpretation and application of: (1) 10 California Code of Regulations ("C.C.R.") § 2644.10(f), which governs which

expenses are considered "institutional advertising" expenses for ratemaking purposes; (2) 10 C.C.R. § 2644.10(a), which requires the exclusion of "political contributions and lobbying" expenses; (3) 10 C.C.R. § 2644.27(f)(9), which permits a "variance" from the regulations when the rate is confiscatory as applied; (4) 10 C.C.R. § 2642.8 and the meaning of "most actuarially sound" as used in this section and throughout the Regulations; and (5) 10 C.C.R. § 2644.27(f)(3), which permits a "variance" from the Regulations when the insurer writes at least 90% of its direct earned premium in one line in California.[2] These regulations are impermissibly vague and arbitrary, have imposed arbitrary rates, have been applied inconsistently and in an arbitrary fashion, have been applied in a manner that constitutes an underground regulation in violation of California law, and have been applied in manner that violates the California and federal constitutions.

8. Accordingly, the Commissioner's Order must be vacated and the Court should issue a declaration as to the proper meaning of the above-referenced sections of the Regulations.

PARTIES

9. Petitioner and plaintiff herein, Mercury Casualty, is a multi-state insurer authorized and licensed to engage in the business of selling property/casualty insurance in California. According to the CDI survey as contained on its website, premiums for Mercury Casualty homeowners policies are among the lowest in the state.

10. Respondent and defendant herein, Dave Jones, is named in his official capacity as Insurance Commissioner of the State of California ("Commissioner"). The Commissioner is required to follow and apply the California Insurance Code and the implementing regulations in a consistent and reasonable manner, and to abide by the California Government Code, and to otherwise discharge his duties according to the law, including the California and United States Constitution. At all times mentioned in this Petition, the Commissioner has been and is now the agency charged with administering Insurance Code sections 1861.05 *et seq.* (Chapter 9, Article 10 ("Reduction and Control of Insurance Rates")).

[2] 10 C.C.R. § 2644.27(a) defines a "variance" request as "[a] request that the maximum permitted earned premium or minimum permitted earned premium should be adjusted."

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JURISDICTION AND VENUE

11. Mercury Casualty has a right to judicial review of the Commissioner's February 11, 2013 Order pursuant to California Insurance Code sections 1861.08, 1861.09, 1858.6 and Government Code section 11523. Mercury Casualty has exhausted all administrative remedies. The Court has jurisdiction over this action seeking a Writ of Administrative Mandamus pursuant to California Code of Civil Procedure section 1094.5. This Court also has jurisdiction over Mercury Casualty's complaint for declaratory relief under Code of Civil Procedure section 1060 and Government Code section 11350 ("Any interested person may obtain a judicial declaration as to the validity of any regulation . . . .").

12. Venue is proper in the County of Sacramento pursuant to Code of Civil Procedure section 393(b), as the Commissioner's February 11, 2013 Order was issued out of his executive office in Sacramento and the State Attorney General maintain official offices in Sacramento.

FACTUAL ALLEGATIONS

Proposition 103

13. On November 8, 1988, the California voters passed Proposition 103. Insurance Code section 1861.05(a), part of Proposition 103, provides: "No rate shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of this chapter. In considering whether a rate is excessive, inadequate or unfairly discriminatory, no consideration shall be given to the degree of competition and the commissioner shall consider whether the rate mathematically reflects the insurance company's investment income."

14. As relevant here, Insurance Code section 1861.05(b) requires "[e]very insurer which desires to change any rate shall file a complete rate application with the commissioner." Under the prior approval regulations ("Regulations"), 10 C.C.R. §§ 2641.1 *et seq.*, an insurer files a rate application containing its request for a rate change with the CDI. The rate application contains, among other things, data reflecting the insurers historical losses and expenses and estimates of future losses and expenses. Through the rate application, an insurer provides information to the Commissioner showing its rate need to enable it to charge a rate that will allow it to cover its losses

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and expenses and be afforded the opportunity to earn a fair rate of return on its investment. The Commissioner reviews the rate application to determine whether the requested rate change seeks a rate that is excessive or inadequate or otherwise complies with Insurance Code section 1861.05(a). He does so by applying the Regulations and the formula contained therein.

The Mercury Casualty Rate Application and Rate Proceeding

15. On or about May 15, 2009, Mercury Casualty filed its rate application with the California Department of Insurance ("CDI") for its Homeowners Multi-Peril line of insurance, RFB App. No. 09-3851 (hereinafter "Application"). In its rate application, Mercury Casualty requested a 3.9% rate increase.

16. On or about June 29, 2009, Consumer Watchdog ("CWD") filed a Petition for Hearing, Petition to Intervene and Notice of Intent to Seek Compensation regarding the Application.

17. On or about July 6, 2009, Mercury Casualty filed its Answer to the Petition.

18. On or about July 10, 2009, Mercury Casualty agreed to toll the statutory 60-day "deemer" period set forth in California Insurance Code § 1861.05(c).

19. On or about July 22, 2009, the CDI approved CWD's Petition for Intervention.

20. On or about May 13, 2011, pursuant to California Insurance Code § 1861.05(c)(2) and 10 C.C.R. section 2648.3, the Commissioner issued a Notice of Hearing wherein he ordered a hearing on the Application. The Commissioner's Notice of Hearing specified the hearing on the Application would be subject to California Insurance Code § 1861.08 and would be held before the Administrative Hearing Bureau of the CDI.

21. On or about June 3, 2011, Administrative Law Judge Kristin L. Rosi ("ALJ") of the CDI's Administrative Hearing Bureau issued a Notice of Scheduling Conference and Order for a scheduling conference to take place on June 29, 2011. The parties agreed to an evidentiary hearing date of December 12, 2011.

22. On October 13, 2011, Mercury Casualty lodged its written direct testimony of several witnesses, including Professor Robert S. Hamada, the Edward Eagle Brown Distinguished Service Professor Emeritus of Finance and former Dean at The University of Chicago Graduate

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School of Business. Professor Hamada's testimony was filed in support of the independent constitutional or confiscation variance contained in 10 C.C.R § 2644.27 (f)(9). The testimony showed that the rates suggested by the CDI and CWD would not provide Mercury Casualty the opportunity to earn a fair rate of return. CWD and the CDI filed motions to strike portions of Mercury Casualty's written direct testimony, including testimony of Professor Hamada.

23. The ALJ granted the motion to strike and erroneously struck the entire testimony of Professor Hamada on the ground that the confiscation related economic testimony constituted impermissible relitigation of the formula contained in the Regulations. The ALJ held that Mercury Casualty could not introduce evidence that the rates suggested by the CDI and CWD denied Mercury Casualty the opportunity to earn a fair rate of return that is commensurate with the returns afforded businesses of comparable risk.

24. On December 8, 2011, Mercury Casualty lodged supplemental testimony of its witnesses, including Dr. David Appel, and included updated loss and trend calculations based on 3rd quarter 2011 data.

25. On December 9, 2011, the ALJ permitted admission of Mercury Casualty's 3rd quarter data, but ordered that no further or updated data may be submitted past the 3rd quarter 2011 regardless of the length of the hearing when a decision would be issued, or when the rate would actually go into effect. The ALJ continued the evidentiary hearing date to December 30, 2011.

26. On December 27, 2011, CWD and the CDI filed motions to strike Dr. Appel's supplemental testimony.

27. On December 30, 2011, the first day of the evidentiary hearing, the ALJ granted the motions to strike Dr. Appel's testimony. The evidentiary hearing was continued to January 3, 2012.

28. On January 3, 2012, Mercury Casualty's counsel requested a continuance of the evidentiary hearing due to a family medical emergency. As a result, the parties agreed to reconvene the evidentiary hearing on January 18, 2012.

29. On January 18, 2012, Mercury Casualty made an Offer of Proof regarding the supplemental direct testimony of Dr. Appel, that Dr. Appel would present testimony that the maximum indicated rate of return presented by the CDI and CWD, based on 3rd quarter 2011 data,

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would be confiscatory as applied. On January 19, 2012, the ALJ granted Mercury Casualty leave to file additional testimony from Dr. Appel. On February 8, 2012, Mercury Casualty lodged additional direct testimony from Dr. Appel.

30. On February 15, 2012, the CWD and CDI filed motions to strike Dr. Appel's confiscation testimony and its accompanying exhibits. On February 21, 2012, the ALJ admitted a portion of Dr. Appel's testimony regarding his understanding of the confiscation variance, but struck Dr. Appel's calculations regarding confiscation and any reference to fair rate of return which she found were based on an economic theory not contained in regulatory formula.

31. The evidentiary hearing reconvened on February 27, 2012 and continued through March 2, 2012.

32. On March 29, 2012, Mercury Casualty lodged its rebuttal testimony from Dr. Appel and Professor Hamada regarding the confiscation variance. On March 30, 2012, CWD and the CDI moved to strike the rebuttal testimony of Dr. Appel and Professor Hamada.

33. On April 2, 2012, the ALJ granted the motion to strike Professor Hamada's rebuttal testimony. Again, the ALJ refused to allow Mercury Casualty's testimony and evidence on the issue of what was a fair rate of return for Mercury Casualty.

34. The ALJ heard rebuttal testimony from April 2 through April 4, 2012.

35. On August 27, 2012, the ALJ issued an order closing the record in the hearing on the Rate Application.

36. On September 26, 2012, the ALJ issued her Proposed Decision on the Rate Application.

<u>The Commissioner's Order Rejecting the ALJ's First Proposed Decision and Certification of Questions for Consideration</u>

37. On October 26, 2012, the Commissioner issued an order rejecting the Proposed Decision, and referring the matter back to the ALJ to take additional evidence on: "The appropriate Loss Trend Selection" and Mercury Casualty's "investment income and its impact on the Company's rate of return."

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38. On November 26, 2012, the ALJ issued an Order Granting the Parties' Joint Motion to Certify Question to the Commissioner ("Certification Order"), and submitted the following certified question to the Commissioner regarding the October 26, 2012 Order: "What issue does the Commissioner wish to see addressed by ordering the parties to provide additional evidence on 'Mercury Casualty Company's investment income and its impact on the Company's rate of return?'" In addition to the certified question, the Certification Order stated that "the parties agree the Commissioner's regulations mandate both the investment income yield and the maximum rate of return," and that "the parties may not stray from the investment and rate factors provided in the regulatory formula."

39. On November 27, 2012, Mercury Casualty requested the ALJ modify the Certification Order to, among other items, correct misstatements concerning Mercury Casualty's position. Specifically, Mercury Casualty stated it did not agree that the regulation mandates the use of the formula's derived investment income yield and the maximum rate of return. "To the contrary, Mercury Casualty has argued in this case, the regulatory formula expressly permits a 'variance' from the use of the regulatory formula insofar as it results in a rate that is confiscatory."

40. On or about January 7, 2013, Mercury Casualty submitted a new Homeowners rate application (CDI File No. 13-716), in which Mercury Casualty is seeking a 6.9% rate increase based upon data through the third quarter of 2012. This rate application is currently pending before the CDI and the CDI has indicated that it must act on the rate application (the 60 day deemer date will run under Insurance Code section 1861.05(c)) by March 26, 2013.

41. On January 14, 2013, the Commissioner issued his Response to the Certified Question, wherein he stated the "Proposed Decision, beginning on page 107, contains a discussion regarding a constitutional variance pursuant to California Code of Regulations, title 10, section 2644.16, subdivision (f)(9). In this section, the ALJ, makes findings of fact regarding Mercury Casualty's after-tax rate of return and profit. In so doing, the ALJ identifies and/or calculates the following terms (among others): underwriting profit; ancillary income; underwriting and other income before tax; before tax profit; after tax profit; before tax annual profit; after tax annual profit; average net income; investment income on reserves and surplus; after-tax return on surplus; and

profit. Because of the inconsistent reference to these terms in the Proposed Decision, it was unclear whether investment income was properly considered in determining Mercury Casualty's after tax rate of return and profit...¶ Based on the lack of clarity in the Proposed Decision, it appeared that the ALJ lacked the requisite evidence regarding Mercury Casualty's investment income and its impact on the rate of return. Accordingly, the Commissioner's Order Rejecting the Proposed Decision and Order of Referral included an order that the ALJ take additional evidence on the following: 'Mercury Casualty Company's investment income and its impact on the Company's rate of return.'" However, the Commissioner, based on the ALJ's Certification Order which misstated the parties' stipulation to the use of the regulatory formula's income investment factors, determined that his October 26, 2012 Order to "take additional evidence on 'Mercury Casualty Company's investment income and its impact on the Company's rate of return,' may be disregarded."

42. On January 18, 2013, Mercury Casualty filed its Petition for Reconsideration of the Commissioner's January 14, 2013 Response to the Certified Question on the ground it was based upon the incorrect understanding that the parties had agreed to the use of the regulatory formula's investment factors in connection with an analysis of its eligibility to a confiscation variance.

43. On January 28, 2013, the ALJ issued an order closing the record and issued a Proposed Decision on the Rate Application. The Proposed Decision was substantively identical to the September 26, 2012 Proposed Decision.

44. On February 8, 2013, Mercury Casualty submitted a brief to the Commissioner regarding errors made by the ALJ in the Proposed Decision, and requested modification and/or rejection of the Proposed Decision.

The Commissioner's Order Adopting the ALJ's Second Proposed Decision

45. On February 11, 2013, the Commissioner issued an Order Adopting Proposed Decision without modification. [Exh. A] The Conclusions of Law in the Proposed Decision provide, in relevant part:

- "All of Mercury's advertising expenses constitute 'institutional advertising' and shall be included in the calculation of Mercury's excluded expense factor." [Exh. A, p.

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128.]

- "Mercury's political expenditures of $183,326 for 2008, $210,656 in 2009, and $528,015 for 2010 shall be included in the calculation of Mercury's excluded expense factor." [Exh. A, p. 128.]
- "Mercury failed to support its request for a variance under California Code of Regulations, title 10, section 2644.27, subdivision (f)(9). Mercury did not satisfy its burden of proof that application of the maximum permitted earned premium results in deep financial hardship to Mercury Casualty as a whole." [Exh. A, p. 129.]
- Mercury Casualty is not entitled the opportunity to earn a fair rate of return on the rates it charges its policyholders [Exh. A, p. 123-126];
- "Mercury failed to support its request for a variance under California Code of Regulations, title 10, section 2644.27, subdivision (f)(3). Mercury did not satisfy its burden of proof that it writes at least 90% of its direct premium in California. In addition, Mercury did not satisfy its burden of proof that its mix of business presents investment risks different from the risks typical of the line as a whole." [Exh. A, p. 128-129.]
- "Mercury shall remove no less than $7,529,928 in catastrophic losses from its policy form HO-3 projected losses as a result of the December 2010 catastrophic rain event." [Exh. A, p. 127.]
- "The regulatory ratemaking formula, without a variance, indicates a rate decrease of 8.18% for Mercury's HO-3 line." [Exh. A, p. 128.]

46. Subsequently, Mercury Casualty filed a petition for reconsideration with the Commissioner, which has not been granted.

47. Mercury Casualty has requested that the administrative record be prepared and delivered.

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FIRST CAUSE OF ACTION

(Writ of Mandamus: CCP Section 1094.5 and Insurance Code Section 1858.6)

48. Mercury Casualty realleges paragraphs 1 through 47 above and incorporates them herein by reference.

49. Pursuant to California Code of Civil Procedure ("CCP") section 1094.5(b), in mandamus proceedings seeking review of administrative orders the Court's inquiry is to extend to the following questions:

- Whether the respondent agency has proceeded without, or in excess of jurisdiction;
- Whether there was a fair trial;
- Whether there was any prejudicial abuse of discretion.

Under section 1094.5(b), "abuse of discretion is established if the respondent [agency] has not proceeded in the manner required by law, the order or decision is not supported by the findings, or the findings are not supported by the evidence."

50. In mandamus proceedings reviewing administrative orders issued by the Insurance Commissioner under the terms of Proposition 103, pursuant to Insurance Code section 1858.6 "the court is authorized and directed to exercise its independent judgment on the evidence and unless the weight of the evidence supports the findings, determination, rule, ruling or order of the commissioner, the same shall be annulled."

51. Through his Order, dated February 11, 2013, the Commissioner has prejudicially abused his discretion in not proceeding in the manner required by law, by issuing an order that is not supported by the findings, and by making findings that are not supported by the weight of the evidence, all as more particularly alleged herein.

1. The Commissioner's Order Must be Set Aside Because the Commissioner Did Not Proceed in the Manner Required by Law in that the Decision was Not Based on the Most Updated Data as Required by Law

52. The Rate Regulations provide, "[i]f updated data underlying the application becomes available during the course of the hearing, the applicant ***shall*** provide the updated data as

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additional direct testimony as soon as practical after the updated data becomes available." 10 C.C.R. § 2655.8(b) (emphasis added).

53. The hearing in this matter was closed on May 21, 2012. Pursuant to the ALJ's December 9, 2011 Order, however, Mercury Casualty was precluded from submitting updated data beyond the 3rd quarter of 2011. There was at least one, if not two, additional quarters (the 4th quarter of 2011 and 1st quarter of 2012) of available updated data that Mercury Casualty was entitled (and required) to present in this hearing but was denied from doing so.

54. The preclusion of post-3rd quarter 2011 data also violated 10.C.C.R. section 2642.6, which provides that the "recorded period" – i.e., the historical period from which data are taken to provide the basis for the proposed rate – must be the "the most recent three years for which reliable data are available …" Though the recorded period must be the most recent three years of data, here, the Commissioner only considered data up to the 3rd quarter of 2011 and thereby ignored nearly a year's worth of data that should have been used to develop rates. In other words, the Order is not based upon data that must be used to develop rates for use in 2013.

55. The preclusion of post-3rd quarter 2011 data also violates the "most actuarially sound" requirements set forth in the Regulations, which requires that the "most actuarially sound" choices be made in connection with various data selections and/or methodologies. *See, e.g.*, 10 C.C.R. §§ 2642.8, 2644.6, 2644.7, & 2644.8. Only through the use of the most current and available data can the "most actuarially sound" selections be made.

56. The failure to consider the post-3rd quarter 2011 data was not only inconsistent with what is required by law, it also prejudiced Mercury Casualty's rights. If Mercury Casualty's 4th quarter 2011 data was considered, the loss ratio for the year ending in the 4th quarter 2011 would be 56.8%, while the loss ratio for the year ending in the 3rd quarter 2011 was determined by the Commissioner to be 48.7%. Such a worsening of Mercury Casualty's loss experience strongly suggests that the determination that a negative, not a positive, loss trend is simply wrong.

57. The infirmity of the Commissioner's Order is further confirmed by Mercury Casualty's recent rate filing, File No. 13-716, which shows that Mercury Casualty has updated data through the 3rd quarter of 2012. Significantly, the recent rate filing uses the values and/or

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methodologies proposed by the ALJ in her September 26, 2012 Proposed Decision and indicates Mercury Casualty is in need of a rate increase of at least 8.2%, not the rate decrease in the Order.

58. Accordingly, the Order should be vacated and remanded so that the Commissioner is ordered to consider Mercury Casualty's post 3rd quarter 2011 data.

2. <u>The Commissioner's Interpretation and Application of "Institutional Advertising" Expenses Set Forth in 10 C.C.R. § 2644.10(f) is Arbitrary, Contrary to the Law and the Evidence and Reflects a Prejudicial Abuse of Discretion</u>

59. California regulations prohibit an insurer from passing on the costs of certain expense items to policyholders, which includes "institutional advertising." 10 C.C.R. § 2644.10, subdivision (f).

60. Based on an erroneous interpretation of the regulation, and contrary to the weight of the evidence, the Commissioner determined that ***all*** of Mercury Casualty's advertising expenses constituted "institutional advertising" and should be included in Mercury Casualty's excluded expense factor. [Exh. A., p. 128.] This erroneous finding lead the Commissioner to conclude that $83 million that Mercury General Corporation spent in advertising from 2008-2010, should be attributed to Mercury Casualty, and thus increasing Mercury Casualty's excluded expense factor.

A. <u>The Commissioner's Decision Incorrectly Holds that Non-Institutional Advertising Requires Mercury Casualty's Advertising to Contain Both (1) Specific Insurer Information and (2) Pertinent Insurance Information, Where the Regulation Only Requires One of these Characteristics to Constitute Non-Institutional Advertising</u>

61. Section 2644.10 provides, in relevant part: "The following expense items shall not be allowed for ratemaking purposes: ¶ (f) Institutional advertising expenses. 'Institutional advertising' means advertising 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." (Emphasis added.)

62. The Commissioner erroneously interpreted and applied the "Institutional advertising expenses" to Mercury Casualty's rate application. Specifically, while the regulation requires a showing of two prerequisites to qualify as "Institutional advertising," the Commissioner determined

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that only one prerequisite need be demonstrated for the expenses of such advertising to constitute "Institutional advertising" and therefore be excluded for ratemaking purposes. This interpretation of the regulation is erroneous and contrary to its plain meaning and prejudiced Mercury Casualty by improperly increasing its expense factor.

B. The Commissioner's Application and Interpretation of "Specific Insurer" in 10 C.C.R. § 2644.10(f) is Arbitrary, Contrary to the Law, and Not Supported by the Evidence

63. The Commissioner's determination that advertisements directed at Mercury Insurance Group, not Mercury Casualty Company, were not aimed at obtaining business for a "specific insurer" is erroneous, contrary to the law, and not supported by the weight of the evidence. Indeed, under the Commissioner's Order affiliated insurers would now have to incur the separate expense of advertising its own company, though the advertising of the group can be done more cost-effectively. There is no logical, actuarial or regulatory reason to prohibit affiliated insurers to advertise on a group-wide basis and take into account, as a legitimate business expense that should be considered for ratemaking, their fairly allocated share of expenses for those advertisements. Instead, a more sensible view of "specific insurer" and consistent with 10 C.C.R., section 2641.17 must contemplate the fact that insurers engage in group advertising and that each specific insurer should be allowed to consider, in developing rates, its share of such expenses.

64. The Commissioner committed further error by relying upon rate applications of other insurers such as State Farm, Travelers, Zurich, Hartford and Liberty Mutual. The Commissioner noted that these companies "exclude substantial institutional advertising expenditures" and that "[g]iven the evidence that Mercury's competitors successfully obey the law the intent and language of the Regulation, the [Commissioner] rejects Mercury's claim that strict adherence would eliminate insurance groups." However, the rate applications relied upon by the Commissioner and which were not introduced into evidence or otherwise addressed in the hearing, provide no information as to what were the advertisements these companies considered "institutional advertisement." In any event, there is reason to believe that these other applications may have had advertising that is not directed at driving insurance business or were listed by the insurers for other unknown reasons. For instance, as the Commissioner noted, State Farm is a group

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of affiliated insurance *and financial service companies*. If State Farm marketed its name to promote both its regulated insurance and non-regulated financial service companies, that may be the basis for State Farm considering at least a portion of those expenses as "institutional" advertisement. In contrast, Mercury Insurance Group only sells insurance and any advertisements have been directed at promoting business and sales through its insurance companies. There is no evidence of what makes up these entries in the other insurer rate filings, which again, were not admitted or tested in the Rate Proceeding. The conclusions reached are at best guesses and there is no support in the record.

65. The weight of the evidence establishes that Mercury Insurance Group's advertisements were directed towards a "specific insurer" to increase its insurance business, and that the advertising expenses for Mercury Insurance Group is accumulated by state in which the advertising takes place and reasonably allocated to each company, including Mercury Casualty, based upon premiums written in that state.

C. The Commissioner's Determination that Mercury Insurance Group's Advertisements Did Not Provide Pertinent Insurance Information is Contrary To and Not Supported by the Evidence

66. The Commissioner's determination that "Mercury fail[ed] to demonstrate significant portions of its advertising provided consumers with pertinent insurance information" is erroneous and not supported by the evidence.

67. Rather than focusing on substantial evidence proffered by Mercury Casualty demonstrating the pertinent insurance information provided by Mercury Insurance Group's advertisements, the Commissioner narrowly focused in on one aspect of Mercury Insurance Group's sports advertising, in particularly, the display of Mercury Insurance Group's logo on the sides of the Los Angeles King's hockey rinks and baseball stadiums or the sponsorship of a tennis tournament as evidence of instances of pure "branding" advertising. This focus, however, ignores the testimony by Mercury Insurance Group's marketing director explaining that these sport sponsorships are part and parcel of a larger, more comprehensive, advertising campaign that is directly geared to providing pertinent insurance information to customers to drive the sale of insurance business.

68. The weight of the evidence shows that Mercury Insurance Group's advertisements

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provide such pertinent information to consumers reasonably calculated to promote insurance sales, and thus they do not constitute "institutional advertising":

(a) The hundreds of pages and print advertisement and DVDs of television advertisements for the years 2008, 2009 and 2010 clearly demonstrate that Mercury Insurance Group's advertisements provide pertinent insurance information to consumers on why they should buy Mercury insurance (e.g., superior rates, coverage and/or customer service) and/or how to obtain a quote (e.g., through Mercury's website or through a Mercury producer).

(b) Mercury Insurance Group's sports advertisement campaigns are a multi-faceted campaign that involve not only the display of Mercury's logo in certain venues, but also the passing out of handouts, the use of radio and TV spots, the inclusion of ads in the program and other banners emphasizing the benefits of Mercury insurance and directing consumers to Mercury's website and/or a designated telephone number.

D. The Commissioner Incorrectly Removed Purported Institutional Advertising Expenses from the Expense Component of the Rate and Reduced the Efficiency Standard Where Only the Efficiency Standard Should Have been Affected

69. The Commissioner's Order removes all of Mercury's advertising of whatever nature from the expense component of the rate. In other words, Mercury Casualty was not allowed to include any advertising expenses as part of the rate. In addition to removing the advertising expense dollars from the rate, the Commissioner also reduced the "efficiency standard," which serve to cap an insurer's expenses, such that additional allowable expenses were arbitrarily and wrongfully reduced.

70. The Commissioner abused his discretion when he arbitrarily removed what he wrongfully characterized as "institutional expenses" from the expense component of the rate and then further reduced expenses by reducing the efficiency standard. This had the effect of arbitrarily and unreasonably double counting the so-called "institutional advertising" expense thereby eliminating allowable expense dollars from the rate.

3. The Commissioner's Interpretation and Application of "Political Contributions and Lobbying" Expenses Set Forth in 10 C.C.R. § 2644.10(a) to Mercury Casualty's Rate Application is Arbitrary, Contrary to the Law and Evidence and Reflects a Prejudicial Abuse of Discretion

71. California regulations prohibit an insurer from passing on the costs of certain expense items to ratepayers, which includes "political contributions and lobbying." 10 C.C.R. § 2644.10, subdivision (a). As a general matter, increasing the insurer's excluded expense factor usually results in a lower overall indicated rate, and a lower efficiency standard.

72. California Code of Regulations, title 10, section 2644.10 provides, in relevant part: "The following expense items shall not be allowed for ratemaking purposes: ¶ (a) Political contributions and lobbying."

73. The Commissioner's Order excluded from Mercury Casualty's rate application the following total amounts designated by Mercury Insurance Group as expenses for political contributions and lobbying - $183,326 for 2008, $210,656 for 2009 and $528,015 for 2010. However, the allocation of the entirety of these expenses to Mercury Casualty is arbitrary and contrary to law as only those expenses allocated to Mercury Casualty should have been excluded.

74. The weight of the evidence also shows that:

(a) The Order improperly includes as Mercury Casualty's excluded expenses for "political contributions and lobbying", expenses of Mercury Insurance Company and Mercury Insurance Group, which should not have been attributed to Mercury Casualty as there is no evidence and no reason to believe that those expenses were allocated to Mercury Casualty.

4. The Commissioner's Interpretation and Application of the Confiscation ("Constitutional") Variance Set Forth in 10 C.C.R. § 2644.27(f)(9) is Arbitrary, Contrary to the Law and Evidence and Reflects a Prejudicial Abuse of Discretion

75. The Commissioner's Order constitutes an abuse of discretion, is in violation of law and is not supported by the weight of the evidence to the extent it determines that Mercury Casualty is not entitled to a Constitutional Variance, and is not entitled to a "fair rate of return."

76. Under the regulations, a confiscation variance is allowed if:

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> "the maximum permitted earned premium would be confiscatory as applied. This is the constitutional mandated variance articulated in *20th Century v. Garamendi* (1994) 8 Cal. 4th 216 which is an end result test applied to the enterprise as a whole." 10 C.C.R. § 2644.27(f)(9).

77. In the Commissioner's comments filed in October 2006 in support of the regulations, the Commissioner stated:

> "Under Proposition 103, as modified by *Calfarm Insurance Co. v. Deukmejian,* (1989) 48 Cal. 3d 805, insurers are entitled to the opportunity to earn a fair and reasonable rate of return. Court decisions interpreting the "fair rate of return" standard make it clear that the opportunity to achieve a fair return must be provided only to those who conduct their operations in a reasonably efficient manner."

78. Notwithstanding his comments in support of the regulations, in the Commissioner's Order he ignored California Supreme Court precedent and rejected application of the "fair rate of return test" established by *20th Century Ins. Co. v. Garamendi* ("*20th Century*"), 8 Cal. 4th 216, 292-296 (1994) ("*20th Century*"). *See Santa Monica Beach, Ltd v. Sup. Court*, 19 Cal. 4th 952, 967 (1999); *Kavanau v. Santa Monica Rent Control Bd.*, 16 Cal. 4th 761, 771 (1997). The Commissioner erred in rejecting the "fair rate of return test," and he should have considered whether the rates proposed by CWD, which the Commissioner adopted, fails to provide a "fair rate of return" and, therefore, is confiscatory. The Commissioner erroneously ruled that "Confiscation is Not Judged Under a "Fair Rate of Return" Standard." [Exh. A, 123.] This is clearly contrary to the most recent California Supreme Court decisions that require a regulated entity must be afforded the opportunity to earn a fair return under any price control scheme.

> "A price control regulation is generally constitutionally challenged with the contention that a particular price or rate regulation is confiscatory, i.e., does not allow a just and reasonable rate to investors. (*See, e.g., 20th Century Ins. Co., supra*, 8 Cal. 4th at p. 293; *Duquesne Light Co. v. Barasch* (1989) 488 U.S. 299 []) … **As we also noted in *Kavanau* and *20th Century Ins. Co.*, courts have employed this fair return analysis in price regulation cases whether the contested regulation is denominated as a taking or a deprivation of property without due process.**"
>
> *Santa Monica Beach, Ltd v. Sup. Court*, 19 Cal. 4th 952, 967 (1999) (bold emph. added).

79. Further, the Commissioner erred in adopting and applying CWD's "confiscation"

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test to determine if the proposed rates were confiscatory. CWD's "confiscation" test is flawed. Under its "confiscation" test, CWD determined that its indicated rate change will result in a fair rate of return of 7.33% and, therefore, cannot be "confiscatory." In reaching this conclusion, however, CWD uses the same values embedded in the regulatory formula (which includes the 7.33% rate of return) that it used to develop its indicated rate change in the first place to conduct a "reverse" calculation that arrives at the presumed 7.33% rate of return value. In other words, this "test" will always yield a 7.33% rate of return and would never show confiscation. It fails to consider Mercury Casualty's actual cost of capital, which is higher than 7.33%. *This* tautological "confiscation" test nullifies and makes superfluous the "confiscation" variance permitted under the regulation and the *20th Century* decision which holds there must be a constitutional variance based on confiscation that is separate and independent from the formula.

80. Under California law, the constitutional variance is to be assessed on an "end result" basis without regard to the formula stated in the regulations. As a result, the constitutional variance must take into account the many expenses the regulations would not recognize. In this regard, the Commissioner erred as a matter of law in excluding testimony from Mercury Casualty's expert regarding the "fair rate of return" standard and by simply adopting the CWD's tautological test.

81. Further, the Commissioner erred in concluding the regulation's "relitigation" provision barred consideration of Mercury Casualty's *actual* projected losses, expense and returns to test the "confiscatory" impact of the proposed rate change. In *20th Century*, the California Supreme Court expressly rejected the proposition that the "relitigation" bar prevents a company from introducing evidence to demonstrate confiscation:

> "The 'relitigation bar,' as noted above, is this: 'Relitigation 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. However, the administrative law judge shall admit evidence he or she finds relevant to the determination of whether the rate is excessive or inadequate (or, in the case of a proceeding [concerning a rate for the rollback year], relevant to the determination of the minimum nonconfiscatory rate), whether or not such evidence is expressly contemplated by these regulations, provided the evidence is not offered for the purpose of relitigating a matter already determined by these regulations or by a generic determination.' (Cal. Code Regs., tit. 10, § 2646.4, subd. (e).)"

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20th Century, supra at 311.

82. An insurer must be allowed to test the confiscatory impact of the rate indication developed by any party by considering an insurer's *actual* expected costs, expenses and returns, not the values as limited and projected under the regulatory formula. Companies must logically be able to test the "end-result" of the regulatory formula by going outside of the formula's constraints (such as those on expenses and costs); otherwise, no company could ever demonstrate confiscation if it were simply required to test the results of the formula with the formula itself.

83. The Commissioner erred in concluding that Mercury Casualty agreed the values in the regulatory formula could be properly used to test "confiscation" and no further data or evidence was needed. The weight of the evidence shows that at all relevant times, Mercury Casualty did not agree or stipulate that the regulatory values, including the investment income factors, could be used to determine Mercury Casualty's **actual** investment income and its **actual** impact upon its rate of return. As the Order is based upon the erroneous premise that Mercury Casualty stipulated to the use of the regulatory values to test confiscation and only considers the values of the regulatory formula (i.e., CWD's "tautological" "confiscation" test discussed above), the Order is wrong and must be vacated.

84. The Commissioner also erred in determining that the proposed rate decrease will not impair Mercury Casualty's financial integrity by relying on Mercury Casualty's historical profitability and financial condition. The consideration of Mercury Casualty's *past* profitability and financial condition under prior rates to assess the impact of the yet-to-be approved rate decrease on Mercury Casualty's *future* profitability and condition is wrong as a matter of law. As the California Supreme Court expressly held:

> "But the concept that rates may be set at less than a fair rate of return in order to compel the return of past surpluses is not one supported by precedent. 'The just compensation safeguarded to the utility by the Fourteenth Amendment is a reasonable return on the value of the property used at the time that it is being used for the public service. . . . [The] law does not require the company to give up for the benefit of future subscribers any part of its accumulations from past operations. **Profits of the past cannot be used to sustain confiscatory rates for the future.**' []"

Calfarm Ins. Co. v. Deukmejian, 48 Cal. 3d 805, 819 (1989) (emph. added).

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Thus, the Commissioner's conclusion that Mercury Casualty's past credit ratings and historic profitability can be maintained under the future, proposed rate decrease is incorrect as a matter of law and without any evidentiary basis.

85. The weight of the evidence shows that the proposed rate decrease, which Mercury Casualty offered through the testimony of its experts, would result in confiscation and not allow for a "fair rate of return."

86. At the hearing, evidence submitted by Mercury Casualty was improperly excluded on the issue of confiscation. The evidence that was stricken by the ALJ included Mercury Casualty evidence on the "fair rate of return" standard for determining whether a proposed rate is confiscatory. This improperly excluded evidence includes, but is not limited to, testimony of Professor Robert S. Hamada submitted on behalf of Mercury Casualty on October 12, 2011 and March 28, 2012, and the testimony of Dr. Appel submitted on December 8, 2011. Other testimony and documents regarding Mercury Casualty's claim of confiscation were excluded as well. The exclusion of this evidence was improper and unlawful and the reviewing court should admit and consider this evidence in exercising its independent judgment and evaluating Mercury Casualty's claims.

87. Finally, the Commissioner erred as a matter of law in concluding that "enterprise as a whole" in the "confiscation" regulation, 10 C.C.R. § 2644.27(f)(9), must refer to the entire insurance company's nationwide operations, and not merely the line of insurance in question in the rate application. Contrary to the Commissioner's interpretation, a line-by-line analysis is consistent with all aspects of ratemaking in California. Insurance Code section 1861.05(a) provides the means of determining whether a rate is inadequate or excessive. That analysis has always been done on a line-by line basis. *See* 10 C.C.R. § 2643(b) ("[r]ate applications … shall be filed on a line-by line basis … Thus, a rate must stand on its own for the line of insurance for which it is being charged."). What an insurer profits from a different line, in another state, is not a factor. How profitable an insurer may be nationally is not considered in determining whether a rate is inadequate or excessive.

88. Accordingly, the for the reasons set forth above, the Order must be vacated as the Commissioner's findings that Mercury Casualty is not entitled to the confiscation variance is in

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violation of law and is not supported by the weight of the evidence, and therefore is an abuse of discretion.

5. <u>The Commissioner's Interpretation and Application of the "Leverage Factor" Under 10 C.C.R. § 2644.27(f)(3) to Mercury's Rate Application is Arbitrary, Contrary to the Law and Evidence and Reflects a Prejudicial Abuse of Discretion</u>

89. California Code of Regulations, title 10, section 2644.27, subdivision (f) provides, in relevant part: "The following are valid bases for requesting a variance: ¶ (3) That the insurer should be authorized leverage factor…on the basis that the insurer either writes at least 90% of its direct earned premium in one line or writes at least 90% of its direct earned premium in California and its mix of business presents investment risks different from the risks that are typical of the line as a whole."

90. The Commissioner, contrary to the regulation, determined that Mercury Casualty does not qualify for this variance even though 95% of its direct earned homeowners premium is in the state of California. The Commissioner erroneously interpreted section 2644.27, subdivision (f)(3) to require Mercury Casualty to demonstrate it writes 90% of its entire direct earned premium on all lines of business in California or 90% of its direct earned premium in just one line of insurance in order to qualify for this variance.

91. Under section 2644.27, subdivision (f)(3), the line of business, not the overall premium of the insurer, is the relevant measuring point.

92. Further, the Commissioner erroneously rejected Mercury Casualty's evidence that its homeowners' insurance concentration in California (95%) presents a risk different from the line as a whole. Mercury Casualty presented undisputed evidence that it is subject to higher capital requirements by A.M. Best because of its high concentration of written premium in California that otherwise would not be required to achieve the same rating as a more diversified insurer.

93. The weight of the evidence shows that:

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(a) Mercury Casualty's 95% direct earned homeowners' premium in the state of California satisfies the variance under section 2644.27, subdivision (f)(3).

(b) Mercury Casualty's 95% homeowners' insurance concentration in California presents risk different from the line as a whole and thus satisfies the variance under section 2644.27, subdivision (f)(3).

(c) Mercury Casualty's 95% direct earned homeowners' premium in the state of California and the different risks this concentration in California presents meets all applicable regulatory requirements in section 2644.27, subdivision (f)(3) and is supported by the weight of the evidence.

94. For each of the reasons stated in paragraphs 1 through 93 above, the Commissioner's Order adopting the ALJ's Proposed Decision constitutes a prejudicial abuse of discretion as the rulings stated therein are in violation of law, not supported by the findings, and not supported by the weight of evidence.

95. Mercury Casualty has exhausted all administrative remedies. Mercury Casualty lacks a "plain, speedy, adequate remedy, in the ordinary course of law" within the meaning of Code of Civil Procedure section 1086.

96. Mercury Casualty is therefore entitled to a writ of mandamus under Code of Civil Procedure section 1094.5 and Insurance Code section 1858.6 that directs the Commissioner to set aside his Order Adopting Proposed Decision, dated February 11, 2013, for each of the reasons set forth above.

SECOND CAUSE OF ACTION

(Declaratory Relief: CCP Section 1060)

97. Mercury Casualty realleges paragraphs 1 through 96 above and incorporates them herein by reference.

98. An actual controversy has arisen and now exists between the parties concerning the Commissioner's interpretation and application of the Regulations to Mercury Casualty's rate application in his Order, specifically: (1) 10 C.C.R. § 2644.10(f), which governs which expenses are considered "institutional advertising" expenses for ratemaking purposes; (2) 10 C.C.R.

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§ 2644.10(a), which requires the exclusion of "political contributions and lobbying" expenses; (3) 10 C.C.R. § 2644.27(f)(9), which permits a "variance" from the regulations when the rate is confiscatory as applied; (4) 10 C.C.R. § 2642.8 and the meaning of "most actuarially sound" as used in this section and throughout the Regulations; and (5) 10 C.C.R. § 2644.27(f)(3), which permits a "variance" from the Regulations when the insurer writes at least 90% of its direct earned premium in one line in California.

99. Mercury Casualty contends the Commissioner misinterpreted and misapplied the above-referenced ratemaking regulations with respect to Mercury Casualty's rate application. As such, Mercury Casualty contends the Commissioner did not proceed in the manner required by law and thus, the Order must be vacated. These regulations are impermissibly vague and arbitrary, have imposed arbitrary rates, have been applied inconsistently and in an arbitrary fashion, have been applied in a manner that constitutes an underground regulation in violation of California law, and have been applied in manner that violates the California and federal constitutions.

<u>10 C.C.R § 2644.10(f) and "Institutional Advertising"</u>

100. Under this subdivision, expenses incurred for "institutional advertising" are not allowed for ratemaking purposes. The Commissioner contends that all advertising is "institutional advertising" unless the advertising seeks to obtain business for an individual insurer <u>and</u> also provides customers with pertinent information.

101. The Commissioner contends that this "institutional advertising" regulatory exclusion means that insurers can only account for advertising expenses in their rates when the advertising seeks to obtain business for an individual insurer and provide customers with pertinent information.

102. The Commissioner's interpretation of "institutional advertising" as set forth in the Regulation is wrong, arbitrary and violative of the California and federal constitutions.

103. "Institutional advertising" is defined in this subdivision as "advertising not aimed at obtaining business for a specific insurer <u>and</u> not providing consumers with information pertinent to the decision whether to buy the insurer's product." 10 Cal. Code Regs. § 2644.10(f) (emph. added).

104. Advertising must satisfy <u>both</u> of the characteristics above to constitute "institutional

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advertising." In other words, an insurer may consider, in developing its rates, expenses for advertising so long as that advertising is either aimed at obtaining business for a specific insurer or it provides consumers with pertinent information. 10 C.C.R. § 2644.10(f). The advertising need only do one of the items above so as to constitute non-institutional advertising such that the expenses for such advertising can be considered for ratemaking.

105. By reason of the Commissioner's interpretation and application of this subdivision, advertisements on behalf of a group of insurance companies, such as "Mercury Insurance Group," are not allowable expenses for ratemaking purposes because such advertisements are not aimed at obtaining business for a "specific insurer" but rather more than one insurer – the group of insurers. In Mercury Casualty's case, that would be three property-casualty insurers in California.

106. Under the Commissioner's interpretation and application of this subdivision, affiliated insurers would now have to incur the separate expense of advertising for its own company, though the advertising of the group can be done more cost-effectively. There is no logical, actuarial or legal reason to prohibit affiliated insurers to advertise on a group-wide basis and take into account, as a legitimate business expense that should be considered for ratemaking, their fairly allocated share of expenses for those advertisements.

107. The Commissioner's interpretation will lead to an absurd result. Under his view, an advertisement for a "specific insurer" is not "institutional advertising" if it only identifies one company, but the same exact advertisement is "institutional advertising" if it happens to name a second company or identifies a group of affiliated insurers. Presuming the advertisement is of a character such that its expense should be properly accounted for in ratemaking, this character should not change simply because the advertisement drives the sale of insurance business for more than one insurance company. Under this view, then effectively **all** insurers would have to exclude **all** of their advertising expenses since all insurance advertising is geared toward the insurance group.

108. A more sensible view of "specific insurer," which is contended by Mercury Casualty, must contemplate the fact that insurers engage in group advertising and that each specific insurer should be allowed to consider, in developing rates, its share of such expenses. *See*, *e.g.*, *People v. Zambia*, 51 Cal. 4th 965, 972 (2011) ("a statute 'must be given a reasonable and common

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sense interpretation consistent with the apparent purpose and intention of the lawmakers, practical rather than technical in nature, which upon application will result in wise policy rather than mischief or absurdity.'"). .

109. The Commissioner also contends that in accounting for the so-called excluded expense for "institutional advertising," the institutional advertising dollars are to be removed from the expense totals in the rate filing and efficiency standard that is used to cap an insurer's expenses for ratemaking purposes is to be reduced by "the ratio of the insurer's national excluded expenses to its national direct earned premium. This will have the effect of arbitrarily and unreasonably double counting the so-called "institutional advertising" expense and eliminate allowable expense dollars from the rate.

10 C.C.R § 2644.10(a) and "Political Contributions and Lobbying"

110. Under this subdivision, expenses incurred for "political contributions and lobbying" are not allowed for ratemaking purposes.

111. In the Order, the Commissioner determined that Mercury Casualty must treat as its own excluded political contributions and lobbying expenses those expenses that were actually incurred and/or allocated to companies other that Mercury Casualty. This determination is based upon an incorrect interpretation and/or application of this regulation as only those expenses actually incurred and/or allocated to Mercury Casualty should have been treated as an excluded expense.

10 C.C.R. § 2644.27 (f)(9) and the Constitutional Variance

112. A separate and independent constitutionally mandated variance is available to an insurer when the maximum permitted earned premium resulting from the application of the Regulations is confiscatory. This "end result constitutional variance" must allow an insurer the opportunity for a return to the equity owner commensurate with the returns on investments and other enterprises having corresponding risks (a "fair rate of return"). Despite this, the Commissioner has adopted a test for determining whether an insurer is entitled to an end result constitutional variance that does not afford an insurer an opportunity for a return on equity that is

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commensurate with the returns on investments and other enterprises having similar risks.

113. The Commissioner has applied this regulation by only considering the components of the regulatory formula and not the end result separate and independent of the formula.

114. In determining confiscation, the Commissioner has also concluded that "enterprise as a whole" depends on the operations of Mercury Casualty and its affiliates all lines of insurance combined. In other words, business operations of Mercury Casualty and its affiliates that are unrelated to the homeowners line of insurance (the subject of the rate application) can subsidize the homeowners rates and allow the Commissioner to impose a confiscatory rate because Mercury Casualty is not precluded from earning a return on other business activities.

115. Contrary to the Commissioner's Order and contention, an insurance line-by-line analysis is consistent with all other aspects of ratemaking in California. Insurance Code section 1861.05(a) provides the means of determining whether a rate is inadequate or excessive. That analysis has always been done on a line-by line basis. What an insurer profits from a different line, in another state, is not a factor. How profitable an insurer may be nationally or as a result of business activities of affiliated companies are not considered in determining whether a rate for a particular insurance line of business is inadequate or excessive. This is confirmed by 10 C.C.R. § 2643.4(b), which provides that "[r]ate applications … shall be filed on a line-by line basis." Thus, a rate must stand on its own for the line of insurance for which it is being charged.

116. In deciding to write homeowners insurance, the key economic decision for Mercury is whether to commit capital to the homeowners line of insurance in California. That decision will depend on the return on capital an investor could earn on the California homeowners insurance business as compared to other investments of similar risk. Thus, the only relevant inquiry in determining confiscation is the impact of the rate on the line of business under review.

117. Under the regulations, surplus is to be allocated to state and line of insurance and not to all lines or all affiliated companies. Thus, even the regulations require a determination of the reasonableness of the rate by considering the individual line of coverage in the rate application.

10 C.C.R. § 2642.8 and the Meaning of "Most Actuarially Sound"

118. Section 2642.8 provides:

> The "most actuarially sound" choice is the most appropriate choice within the range of permissible actuarially sound choices, considering both the relative likelihood of all choices within the range and the context in which the choice will be employed.

119. This regulation is impermissibly vague and provides no guidance or direction to allow consistent application to all insurers. There is no one "most actuarially sound" method. In accordance with actuarial principles, an insurer must show that it is using sound and reasonable actuarial methods. To the extent this regulation seeks the "most actuarially sound" choice, it provides no definition or standard by which to determine on a consistent basis or otherwise what is the most actuarially sound choice. It is unclear, vague and ambiguous as to how the Commissioner will determine whether one choice is more actuarially sound than another actuarially sound choice. The vagueness of this subdivision and lack of standards precludes insurers from knowing what criteria will be used for determining what is most actuarially sound.

120. The vagueness of this regulation is compounded by the use of terms "most actuarially sound" throughout the Regulations. For example, under 10 C.C.R. § 2644.7, insurers are to file rate applications "using the single data period that it determines to be "most actuarially sound." Under section 2644.8, an insurer is required to demonstrate that the defense and cost containment expenses it selects is the "most actuarially sound." There are numerous other instances throughout the Regulations of the use the terminology "most actuarially sound" as referred to section 2642.8 and these are just two examples. In the Mercury Rate Proceeding, Mercury's most actuarially sound choices were rejected without any standard or uniform criteria to the detriment of Mercury.

10 C.C.R. § 2644.27 (f)(3) and the 90% Concentration Variance

121. The Commissioner determined that section 2644.27 (f)(3) requires an insurer to write 90% of its direct earned premium in one line or in California and that its mix of business presents investment risks different from the risks that are typical of the line as a whole.

122. This interpretation is arbitrary and capricious. In determining whether a variance is

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warranted, the line of business, not the overall premium of the insurer, should be the relevant yardstick as is reflected by remedy under this variance.

123. Under section 2644.27(f)(3), when an insurer qualifies for this variance, the leverage factor for the line of business under review (e.g. homeowners) is adjusted by multiply it by 0.85. Given that the variance is directed to providing relief in the form of allowing more surplus to support the line of business, it only makes sense that the relevant inquiry is the line of business.

124. The Commissioner has also determined that the meaning of "mix of business" refers to an insurer's mix of investments. This too makes no sense. Rather, concentration of an insurer's line of business in California should be the relevant inquiry. For Mercury, its mix of business of its heavily concentrated homeowners line of business presents risks that are different from the line as a whole. For instance, it is subject to higher capital requirements by A.M. Best due to the high concentration of written premium in California required to achieve the same rating as a more diversified insurer.

125. This variance recognizes the greater risk associated with highly concentrated insurance operations. Under such circumstances it is economically prudent to allocate additional surplus to the activity, in order to stabilize overall returns and reduce the probability of default. For Mercury, based on the distribution of Mercury's homeowners' business, and this understanding of how the leverage factors in the formula were developed, Mercury should be granted the requested variance in this matter had the regulation been properly applied.

126. The Commissioner contends in all respects to the contrary of Mercury's contentions regarding the interpretation, meaning and application of the above-referenced Regulations. The Commissioner disputes that he did not proceed in the manner required by law in interpreting and applying the above-referenced regulations generally or to Mercury Casualty's rate application. The Commissioner contends his interpretation and application of the above-referenced Regulations is consistent with all applicable laws.

127. Mercury Casualty is entitled to a determination of the validity of the Commissioner's Order and the interpretation and application of (1) 10 C.C.R. § 2644.10 (f); (2) 10 C.C.R. § 2644.10(a); (3) 10 C.C.R. § 2644.27 (f)(9); (4) 10 C.C.R. § 2642.8; and (5) 10 C.C.R. §

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2644.27, (f)(3).

128. Mercury Casualty has exhausted all administrative remedies and a declaration is necessary and proper at this time under all circumstances.

THIRD CAUSE OF ACTION

(For Injunctive Relief Enjoining or Staying Enforcement of the Commissioner's Order)

129. Mercury Casualty realleges paragraphs 1 through 128 above and incorporates them herein by reference.

130. If Mercury Casualty is compelled to implement the reduction of its homeowners rates pursuant to the Commissioner's Order, Mercury will be reducing rates for policyholders and receiving premium at the reduced rate notwithstanding the unlawfulness of the Commissioner's Order as alleged herein. Once the rates are wrongfully reduced and coverage afforded to the policyholders, upon the Court's determination in response to this Writ and Complaint that the Commissioner's Order should be vacated and the rate reduction declared a nullity, Mercury Casualty will not be able to recover the additional premium (the amount of the wrongful reduction plus the increase Mercury Casualty is otherwise entitled to) from its policyholders. There is no remedy available to Mercury to recover amounts it will lose by reason of the implementation of the rate reduction before judicial review and the coverage it afforded at an unlawful rate.

131. In contrast to the loss Mercury Casualty will suffer by reason of the premature implementation of the Commissioner's Order, Mercury Casualty can track those policyholders who would be entitled to a rate decrease if the Court determines after judicial review not to vacate the Commissioner's Order. Mercury Casualty can refund amounts to those policyholders and the policyholders will suffer no harm.

132. In addition, on or about January 7, 2013, Mercury Casualty submitted a new Homeowners rate application (CDI File No. 13-716), in which Mercury Casualty is seeking a 6.9% rate increase based upon data through the third quarter of 2012. This is the data Mercury Casualty requested the ALJ and the Commissioner to consider because it shows that the rate decrease set forth in the Commissioner's Order is not supported by the data. What this rate application clearly

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shows is that Mercury Casualty rates should not be decreased. Indeed, Mercury Casualty adopted the ratemaking components set forth in the Commissioner's Order (without waiver of its disagreement with those components) and then added the data through the third quarter 2012. Thus, even under the approach laid out in the Commissioner's Order as applied to the more current data, Mercury is entitled to an increase and not a decrease. This rate application is currently pending before the CDI and the CDI has indicated that it must act on the rate application (the 60 day deemer date will run under Insurance Code section 1861.05(c)) by March 26, 2013.

133. Given the likelihood that the ordered rate decrease will be declared invalid for the reasons set forth in this Writ and Complaint, and Mercury Casualty's ability to take steps to ensure its policyholders will be made whole in the unlikely event Mercury Casualty does not prevail, Mercury Casualty is seeking to preserve the status quo pending judicial review because of the irreparable and substantial harm and injury that will occur to Mercury Casualty as a result of the enforcement of the Commissioner's Order imposing an arbitrary and unlawful rate.

134. Mercury Casualty has no adequate remedy at law.

135. Mercury Casualty seeks a permanent injunction enjoining the Commissioner from enforcing Commissioner's Order.

PRAYER

WHEREFORE, Mercury Casualty prays for judgment as follows:

1. That this Court issue a peremptory writ of mandamus directing and compelling the Commissioner to vacate his February 11, 2013 Order,

2. That this Court issue a peremptory writ of mandamus directing and compelling the Commissioner to grant the rate increase requested by Mercury Casualty,

3. For a declaration regarding the scope and meaning of: (1) 10 C.C.R. § 2644.10(f); (2) 10 C.C.R. § 2644.10(a); (3) 10 C.C.R. § 2644.27(f)(9); (4) 10 C.C.R. § 2642.8; and (5) 10 C.C.R. § 2644.27(f)(3).

4. That this Court enjoin or otherwise stay enforcement of the February 11, 2013 Order until this action is resolved,

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5. Plaintiffs request the recovery of attorneys' fees pursuant to Code of Civil Procedure Insurance Code section 12926.1(d)(2).

6. For such other or further relief as the Court may deem just and proper.

Dated: March 1, 2013

BARGER & WOLEN LLP

By: ____________________

STEVEN H. WEINSTEIN
MARINA M. KARVELAS
SPENCER Y. KOOK
PETER SINDHUPHAK
Attorneys for Petitioner/Plaintiff Mercury Casualty Company

VERIFICATION

Steven H. Weinstein declares as follows:

I am an attorney with the law firm of Barger & Wolen licensed to practice in California. I am one of the attorneys at my firm with the primary responsibility for the handling of this action. I have been representing Mercury Casualty Company in connection with the matters alleged in this Petition for Peremptory Writ of Mandate ("Petition"). I have personal knowledge of the matters alleged in the Petition. All Exhibits accompanying and filed in support of this Petition are true and correct copies of documents on file with the Commissioner. If called to testify as a witness, I could and would be able to testify competently as to such matters alleged in the Petition. I am authorized to make this verification on behalf of Mercury Casualty Company.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Executed on March 1, 2013 at Los Angeles, California.

By: ______________________
Steven H. Weinstein

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LOS ANGELES, CA 90071
(213) 680-2800

EXHIBIT A

DEPARTMENT OF INSURANCE
EXECUTIVE OFFICE
300 Capitol Mall, 17th Floor
Sacramento, CA 95814
Tel. (916) 492-3500 Fax (916) 445-5280

BEFORE THE INSURANCE COMMISSIONER

OF THE STATE OF CALIFORNIA

In the Matter of the Rate Application of: **MERCURY CASUALTY COMPANY,** Applicant.	File No. PA-2009-00009 **ORDER ADOPTING PROPOSED DECISION** (Cal. Ins. Code §§ 1861.05, 1861.08 and Cal. Govt. Code § 11517(c))

This matter came for hearing before Kristin L. Rosi, Administrative Law Judge (hereafter "ALJ") of the Administrative Hearing Bureau. On January 28, 2013, the ALJ closed the record and on January 30, 2013, submitted her proposed decision and recommended its adoption as the decision of the Commissioner.

Now, therefore, pursuant to the provisions of California Insurance Code Section 1861.08(c) and California Government Code Section 11517(c)(2)(A), IT IS SO ORDERED that the attached proposed decision is hereby adopted by the Insurance Commissioner as his Decision in the above entitled matter.

Reconsideration of this Decision may be had pursuant to California Government Code Section 11521 and California Code of Regulations, Title 10, Section 2659.1. The power to order Reconsideration shall expire thirty (30) days after service the decision on the parties, but not later than the effective date of the decision.

//

A Petition for Reconsideration must be served on all parties, with a copy filed with the Administrative Hearing Bureau, and should be directed to:

Geoffrey F. Margolis
Deputy Commissioner & Special Counsel
California Department of Insurance – Executive Office
300 Capitol Mall, 17th Floor
Sacramento, California 95814

Judicial review of the Insurance Commissioner's Decision may be had pursuant to California Insurance Code Sections 1858.6 and 1861.09, California Government Code Section 11523, and California Code of Regulations, Title 10, Section 2660, by filing a petition for a writ of mandate in accordance with the provisions of the California Code of Civil Procedure. The right to petition shall not be affected by the failure to seek reconsideration before the Commissioner.

A Petition for a Writ of Mandamus shall be filed with the Court, and served on the Insurance Commissioner as follows:

Darrel Woo
Senior Staff Counsel
California Department of Insurance – Legal Office
300 Capitol Mall, 17th Floor
Sacramento, California 95814

Any Petition for a Writ of Mandamus should also be served on the Administrative Hearing Bureau of the California Department of Insurance as follows:

Department of Insurance
Administrative Hearing Bureau
45 Freemont Street, 22nd Floor
San Francisco, California 94105

IN WITNESS WHEREOF, I have hereunto set my hand and affixed it by this official seal, this 11th day of February, 2013.

DAVE JONES
Insurance Commissioner

By: ______________________
GEOFFREY F. MARGOLIS
Deputy Commissioner & Special Counsel

DEPARTMENT OF INSURANCE
ADMINISTRATIVE HEARING BUREAU
45 Fremont Street, 22nd Floor
San Francisco, CA 94105
Telephone: (415) 538-4251 or (415) 538-4102
FAX No.: (415) 904-5854

BEFORE THE INSURANCE COMMISSIONER

OF THE STATE OF CALIFORNIA

In the Matter of the Rate Application of **MERCURY CASUALTY COMPANY,** Applicant.	)))))))	FILE NO.: PA-2009-00009

PROPOSED DECISION ON REMAND

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Introduction

I. Background

Between 1986 and 1988, Californians watched their auto insurance premiums jump 40%, even as inflation slowed and accident rates declined. In fact, about the only thing in California that cost more than a beach house in Malibu was the insurance on the car people drove to get them there.[1] Of course, that assumed one could find an insurer willing to sell liability insurance at all. While California law required proof of financial responsibility, residents of California's inner cities had considerable difficulty obtaining insurance. And if they could find coverage, these citizens soon realized that regardless of their driving history their premiums were much higher than their fellow Californians in other parts of the state. [2] Thus, the stage was set for a populist response in California; a state where property and liability insurance premiums were already among the highest.

In 1988, consumer advocacy groups drafted a ballot amendment aimed at reforming California's insurance marketplace. This ballot amendment, titled Proposition 103, mandated a 20% rollback in insurance premiums and sought to do away with the open competition system of insurance rates in favor of a prior approval system.[3] The initiative provided that no rate shall be approved or remain in effect which is excessive, inadequate, or unfairly discriminatory.

> In considering whether a rate is excessive, inadequate or unfairly discriminatory, no consideration shall be given to the degree of competition and the commissioner shall consider whether the rate mathematically reflects the insurance company's investment income.[4]

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[1] Armstrong, *California Car Insurance Revolt*, Christian Science Monitor (Feb. 22, 1988) p. 3.
[2] See, *King v. Meese* (1987) 43 Cal.3d 1217, 1238.
[3] *20th Century Co. v. Garamendi* (1994) 8 Cal.4th 216, 300.
[4] Ins. Code § 1861.05(a).

On Election Day in 1988, 51% of California voters approved Proposition 103. The insurance industry responded with a flurry of lawsuits and proposed legislation. When the dust settled nearly six years later, the fundamental provisions of Proposition 103, including those calling for prior approval of insurance rates, remained intact.[5]

II. Regulatory Formula

Under the Commissioner's prior approval regulations, an insurer may set for itself whatever rate it chooses, provided the rate is neither excessive nor inadequate.[6] Using a consistent methodology, the Commissioner determines whether rates are excessive or inadequate on the basis of the aggregate earned premium the rates are expected to produce.[7] In simpler terms, the Commissioner determines both the maximum and minimum permitted earned premium through use of a regulatory formula.[8] The maximum permitted earned premium is determined by the following formula:[9]

$$\frac{\textit{(losses + defense and containment costs) x (1-fixed invest. income factor) – ancil. income}}{\textit{1.0 – efficiency standard – profit factor + variable investment income factor}}$$

A rate is excessive if it is higher than the maximum permitted earned premium and inadequate if it is lower than the minimum permitted earned premium.[10] Where the Commissioner finds a proposed rate is excessive, the rate shall not be used. Instead the Commissioner shall indicate the highest rate that would not be excessive.[11] The insurer shall adopt the Commissioner's indicated rate or face rejection of the rate in its entirety. Parties requesting relief from the maximum and minimum permitted earned premium

[5] Proposition 103 is codified at Insurance Code section 1861.01 et seq.
[6] Cal. Code Regs., tit. 10, § 2641.1 et seq.
[7] Cal. Code Regs., tit. 10, § 2643.3, subd. (a).
[8] The formulas for calculating the maximum and minimum earned premiums are identical, with the exception of the applicable profit factor. The maximum profit factor is applied to determine the maximum premium, while the minimum profit factor is applied to determine the lower end of permitted premiums.
[9] Cal. Code Regs., tit. 10, § 2644.2.
[10] Cal. Code Regs., tit. 10, § 2644.1.
[11] *Ibid.*

calculations may request one or more variances and thus an alternate rate. The burden of proving, by a preponderance of the evidence, every fact necessary to show that its rate is not excessive, inadequate or unfairly discriminatory rests with the insurer.[12]

Mercury Casualty Company applies for a rate increase of 8.8% in its homeowner's lines including application of the leverage variance, and a 6.9% increase without the leverage variance. Mercury also contends any rate increase less than 6.9% would be confiscatory.

The California Department of Insurance (CDI) contests Mercury's rate application and asserts the maximum permitted combined rate change should be -2.33%. The Intervenor, Consumer Watchdog, contends Mercury's proposed rate is excessive and a combined rate decrease of 5.8% would be correct. Both Consumer Watchdog and the CDI dispute Mercury's variance requests.

Summary of Findings

Having considered the parties' evidence and arguments, the Administrative Law Judge concludes that Mercury's proposed rate increase of 8.8% is excessive. Instead, the rate formula supports a maximum indicated rate of -8.18% for HO-3, 4.32% for HO-4 and 29.44% for HO-6.[13] Mercury also failed to prove by a preponderance of the evidence it was entitled to a leverage variance or that an increase of less than 8.8% would be confiscatory.

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[12] Cal. Code Regs., tit. 10, § 2646.5; *In the Matter of the Rate Application of American Healthcare Indemnity Company*, PA-2002-25739, pp. 10-11.

[13] Policy form HO-3 is a form of residential homeowner's insurance. Policy form HO-4 applies to renters and tenants while policy form HO-6 applies to condominium owners.

Procedural History

On May 1, 2009, Mercury filed rate application No. 09-3851 concerning its Homeowner's Multi-Peril line of insurance. On June 29, 2009, Consumer Watchdog filed a Petition for Hearing and a Petition to Intervene.[14] Mercury filed its Answer to the Petition on July 6, 2009. In addition, Mercury agreed to toll the statutory 60-day "deemer" period through its letter dated July 10, 2009.

On May 13, 2011, CDI issued a Notice of Hearing. Administrative Law Judge (ALJ) Kristin L. Rosi held a scheduling conference on June 29, 2011, during which the ALJ set deadlines for filing discovery motions, direct written testimony, motions to strike, as well as a date for the evidentiary hearing. The parties agreed to an evidentiary hearing date of December 12, 2011.

On September 12, 2011, CDI filed a Motion to Compel Discovery alleging Mercury failed to produce relevant and necessary documents. On September 15, 2011, Consumer Watchdog filed a similar Motion to Compel Discovery against Mercury. In response, Mercury filed its own Motion to Compel Discovery requesting Consumer Watchdog produce all working papers of its potential expert witness. Following a hearing on the motions, the ALJ granted in part, and denied in part, CDI's and Consumer Watchdog's motions.[15] In addition, the ALJ conditionally granted Mercury's motion.

On October 13, 2011, Mercury lodged the written direct testimony of Chong Gao, Irene K. Bass, Robert C. Fox, Dr. Robert S. Hamada and Dr. David Appel. CDI and Consumer Watchdog filed timely Motions to Strike portions of the direct testimony of each witness. After hearing oral argument on the motions, the ALJ issued orders granting

[14] CDI approved Consumer Watchdog's Petition for Intervention on July 22, 2009.

[15] Final Rulings and Order on Motion to Compel Discovery by Consumer Watchdog, issued October 3, 2011.

in part, and denying in part, the motions to strike.[16] Notably, the ALJ's Order found much of Mercury's testimony in support of Variance 9, the "confiscation" variance, irrelevant and an impermissible relitigation of the regulatory formula, remarking that earlier prior approval cases struck identical testimony on the same grounds.[17] But, the ALJ also indicated confiscation testimony might become relevant upon a showing by Mercury that the maximum permitted earned premium resulted in deep financial hardship to Mercury's enterprise as a whole.[18]

On November 9, 2011, Consumer Watchdog lodged the written direct testimony of Allan J. Schwartz. On that same date, CDI lodged the written direct testimony of Nicholas Adam Gammell. On November 17, 2011, Mercury filed a Motion to Strike Mr. Gammell's testimony arguing CDI must designate Mr. Gammell as an expert witness. Following a hearing on this motion, the ALJ issued an order denying the motion, but instructing CDI to provide additional information demonstrating Mr. Gammell's calculations.[19]

On December 8, 2011, four days prior to the commencement of the evidentiary hearing, Mercury lodged supplemental testimony by Ms. Gao and Dr. Appel, along with updated loss and trend calculations based on 3rd quarter 2011 data. Inclusion of the 3rd quarter data resulted in a revised rate application by Mercury. On December 9, 2011, the ALJ held an unreported telephonic status conference to discuss receipt of the 3rd quarter information. After considering the parties arguments, the ALJ ordered admission of Mercury's 3rd quarter 2011 data. Further, the ALJ ordered a continuance of the

[16] Final Rulings and Order on Motions to Strike Applicant's Direct Testimony, issued November 4, 2011.
[17] *Id.* at pp. 4-8.
[18] *Id.* at pp. 5-6.
[19] Final Rulings and Order on Motion to Strike CDI's Direct Testimony, issued December 6, 2011.

evidentiary hearing in order to allow CDI and Consumer Watchdog time to analyze the amended rate application.[20] The ALJ set a new evidentiary hearing date of December 30, 2011.

On December 27, 2011, Consumer Watchdog and CDI filed Motions to Strike Dr. Appel's supplemental direct testimony, arguing the additional testimony was irrelevant and an attempt by Mercury to revisit previously stricken testimony. On December 30, 2011, in conjunction with the first day of evidentiary hearing, the ALJ heard oral argument on the Motions to Strike. On that same date, the ALJ granted the motions to strike Dr. Appel's supplemental testimony, and continued the evidentiary hearing until January 4, 2012.

On January 3, 2012, Mercury's counsel requested a continuance of the evidentiary hearing due to a family medical emergency. On January 4, 2012, the ALJ held an unreported telephonic status conference to calendar additional evidentiary hearing dates. The parties agreed to reconvene the evidentiary hearing on January 18, 2012.[21]

The evidentiary hearing resumed on January 18, and continued through January 20, 2012, with additional hearing dates scheduled for the week of February 27, 2012.

On January 18, 2012, Mercury made an Offer of Proof regarding the supplemental direct testimony of Dr. Appel. Mercury asserted that if permitted, Dr. Appel would present testimony that the maximum indicated rate of return presented by the CDI and Consumer Watchdog, based on 3rd quarter 2011 data, would be confiscatory as applied. On January 19, 2012, pursuant to California Code of Regulations, title 10, section 2644.7, subsection (c), the ALJ granted Mercury leave to file additional testimony from Dr.

[20] Order Granting CDI's Request for a Continuance, issued December 9, 2011.
[21] Order Granting Mercury's Request for a Continuance, issued January 5, 2012.

Appel. The ALJ admonished Mercury not to simply restate Dr. Appel's previously stricken testimony and foreclosed further updated data.[22]

On February 8, 2012, Mercury again filed supplemental testimony from Dr. Appel, along with Dr. Appel's accompanying calculations, focusing entirely on the confiscation variance. On February 10, 2012, pursuant to the ALJ's Order, Mercury lodged the direct written testimony of Erik Thompson and David Yeager in conjunction with an additional 500 pages of evidence regarding Mercury's excluded expenses and advertising expenditures.

On February 15, 2012, the CDI and Consumer Watchdog filed timely Motions to Strike Dr. Appel's confiscation testimony and its accompanying exhibits. On February 21, 2012, the ALJ admitted Dr. Appel's testimony regarding his understanding of the confiscation variance, but struck Dr. Appel's calculations which were based on an alternative economic theory to the regulatory formula.[23]

The evidentiary hearing reconvened on February 27, 2012 and continued through March 2, 2012.

On March 20, 2012, Mercury lodged the pre-filed testimony of Donald S. Windeler, Jr. as well as the rebuttal testimony of Dr. Appel and Ms. Bass. On that same date, CDI filed the written direct testimony of Dr. Mukarram Attari. On March 27, 2012, Consumer Watchdog moved to strike Mr. Windeler's testimony as improper rebuttal testimony.

On March 29, 2012, Mercury lodged additional rebuttal testimony from Dr. Appel and Dr. Hamada regarding the confiscation variance. On March 30, 2012, Consumer

[22] Order Regarding Supplemental Direct Testimony, issued January 25, 2012.
[23] Order on Motion to Strike Dr. Appel's Supplemental Testimony, issued February 21, 2012.

Watchdog and the CDI filed Motions to Strike the rebuttal testimony of Dr. Appel and Dr. Hamada.

The ALJ heard live rebuttal testimony from April 2 through April 4, 2012. Prior to commencing rebuttal testimony, the ALJ orally granted Consumer Watchdog's Motion to Strike portions of Dr. Hamada's rebuttal testimony, while denying Consumer Watchdog's Motion to Strike Dr. Appel's and Mr. Windeler's rebuttal testimony. On April 4, 2012, Consumer Watchdog lodged the rebuttal testimony of Mr. Schwartz while Mercury pre-filed the supplemental rebuttal testimony of Ms. Bass.

In accordance with the ALJ's Order dated April 11, 2012, on April 24, 2012, Ms. Gao and Mr. Yeager filed additional testimony, responding to specific questions from the ALJ. On May 4, 2012, Mr. Gammell and Mr. Schwartz filed testimony in response to Ms. Gao and Mr. Yeager's supplemental testimony.

The parties filed post-hearing opening briefs on June 20, 2012 and reply briefs on July 19, 2012. On July 20, 2012, Consumer Watchdog filed a Request for Official Notice asking the ALJ to take notice of the regulatory history of Regulation section 2642.6. On July 27, 2012, the Department filed a Motion to Strike Mercury's post-hearing reply brief on the grounds that the brief exceed the regulatory length and included erroneous statements of fact and law.

On August 3, 2012, the ALJ held a reported telephonic conference to hear arguments on the Request for Official Notice and Motion to Strike. The ALJ subsequently denied both the Request for Official Notice and the Motion to Strike, but ordered Mercury to file a conforming post-hearing reply brief.[24]

[24] Order on Post-Hearing Motion to Strike and Request for Official Notice, issued August 7, 2012.

The ALJ closed the record on August 27, 2012 and submitted the matter for decision. On September 27, 2012, the ALJ submitted a Proposed Decision to the Commissioner and recommended its adoption.

On October 26, 2012, the Commissioner rejected the Proposed Decision and referred the matter back to the ALJ for additional evidence (Remand Order). Specifically, the Commissioner requested additional evidence on (1) the appropriate loss trends for policy forms HO-4 and HO-6, and (2) Mercury Casualty Company's investment income and its impact on the Company's rate of return.[25]

On November 9, 2012, the parties participated in a status conference regarding the Commissioner's Remand Order. At the status conference, the parties stated that they had no additional evidence to introduce on the loss trends for HO-4 and HO-6 and agreed to stipulate to that fact. All parties also expressed confusion over the nature and scope of the Commissioner's request for additional evidence on Mercury's investment income and its impact on the rate of return, since the Commissioner's regulatory formula mandates both the investment income yield and the after-tax risk free rate of return. The ALJ orally granted the parties' joint motion to certify the following question to the Commissioner, pursuant to California Code of Regulations, title 10, section 2646.2: "What issue does the Commissioner wish to see addressed by ordering the parties to provide additional evidence on Mercury Casualty Company's investment income and its impact on the Company's rate of return?"[26]

On December 12, 2012, the parties stipulated that no additional evidence exists that would assist the trier of fact in evaluating the loss trends for policy forms HO-4 and

[25] Order Rejecting Proposed Decision and Order of Referral, issued October 26, 2012.
[26] Order Granting Parties' Joint Motion to Certify Question to the Commissioner, issued November 26, 2012.

HO-6.[27] The ALJ identified the Stipulation as ALJ Exhibit 1 and admitted the Stipulation into evidence.

On January 16, 2013, the Commissioner responded to the certified question. After acknowledging that the parties agreed to use investment income factors in place on September 30, 2011, the Commissioner stated the October 26, 2012 Remand Order to take additional evidence on Mercury's investment income and its impact on the Company's rate of return "may be disregarded."[28]

On January 22, 2013, Mercury petitioned the Commissioner to reconsider his response to the certified question.[29] Specifically, Mercury suggested the Commissioner's Remand Order pertained not to the September 30, 2011 regulatory factors, but instead meant to reopen the test for confiscation.

On January 28, 2013, the Commissioner rejected Mercury's Petition for Reconsideration of the Certified Question. On that same date, the ALJ re-closed the record and submitted the matter for decision on remand.

Disputed Issues

On September 30, 2011, the parties filed a Joint Statement of Issues and Facts identifying those issues that remain in dispute. The issues to be determined are:

1. What is the maximum permitted earned premium produced by the regulatory formula absent a variance?

2. Does Mercury qualify for a leverage variance pursuant to California Code of Regulations, title 10, section 2644.27, subdivision (f)(3)?

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[27] Stipulation Regarding Loss Trend Evidence, filed December 28, 2012.
[28] Commissioner's Response to Certified Question, filed January 16, 2013.
[29] Mercury's Petition for Reconsideration of Response to Certified Question, filed January 22, 2013.

3. Does Mercury qualify for a confiscation variance pursuant to California Code of Regulations, title 10, section 2644.27, subdivision (f)(9)?

Parties' Contentions

The parties disagree on the proper value of projected losses, the catastrophe adjustment, loss development, loss and premium trend, projected defense and cost containment, leverage factor and surplus, and trended current rate level earned premium. In addition, the parties differ on the amount of excluded expenses and the efficiency standard, as well as whether Mercury qualifies for leverage and confiscation variances. All in all, the parties disagree on 15 separate issues.

Mercury contends it properly included rain and roof leak damages from December 2010 in its rate application and provided adequate actuarial support for the use of a catastrophe model, thereby appropriately calculating the projected losses, catastrophe adjustment, loss development and trends. Likewise, Mercury asserts it properly calculated the amount of excluded expenses and produced an accurate efficiency standard. Mercury argues its operations qualify for a "leverage" variance, as Mercury writes at least 90% of its direct earned premium in California. Finally, Mercury contends any rate increase less than 6.9% will result in confiscation.

CDI and Consumer Watchdog dispute Mercury's projected losses and catastrophe adjustment, arguing Mercury's December 2010 rain losses constitute a "catastrophe" and thus must be excluded from projected losses. The CDI and Consumer Watchdog also disagree with Mercury's trend selection, loss development factors, catastrophe adjustment, and projected defense and cost containment expenses. In addition, Consumer Watchdog disputes Mercury's excluded expense amounts and asserts Mercury failed to adequately support the use of a catastrophe model. Both CDI and Consumer Watchdog reject Mercury's claims for leverage and confiscation variances.

Discussion

I. Maximum Permitted Rate Without A Variance

In order to develop the maximum earned premium, the Commissioner must calculate an insurer's projected losses, projected defense and cost containment expenses, excluded expense factor, and efficiency standard. The parties do not agree on the proper values for any of these items. Accordingly, before the ALJ can determine the maximum permitted earned premium, a finding on each of the above items is necessary.

A. Projected Losses

An insurer's projected losses significantly impact the maximum and minimum permitted earned premiums as calculated by the regulatory formula. Thus, the bulk of this decision pertains to how the Commissioner should calculate projected losses. The Regulations calculate projected losses based on a number of factors, including an insurer's historic losses per exposure, modified by a catastrophe adjustment, loss development and loss trend.[30] The parties disagree on: (1) whether Mercury suffered a catastrophic loss in December 2010; (2) the amount of Mercury's non-modeled December 2010 catastrophic losses; (3) Mercury's non-modeled catastrophe adjustment factor; (4) Mercury's use of a fire following earthquake model; (5) Mercury's fire following earthquake losses and load; (6) Mercury's correct loss development factors; and (7) Mercury's trend selections.

Each of the seven factors at issue is addressed separately below.

[30] Cal. Code Regs., tit. 10, § 2644.4, subd. (a).

1. Catastrophic Losses

Many property/casualty insurance products are, by their nature, subject to large aggregate losses as a result of relatively infrequent events or natural phenomena. These catastrophic losses can cause extreme volatility in historical insurance data and generally require separate and different treatment from other losses in ratemaking methodologies.[31] If an insurer includes catastrophic losses in the ratemaking analysis, the indicated rates may increase immediately after a year with large losses and may decrease when there are no catastrophic losses present in the experience period. Consequently, regulators and actuaries typically remove catastrophic losses from ratemaking data to avoid distorting the ratemaking analysis. Actual catastrophe losses are replaced with an average expected catastrophe loss amount; the catastrophe adjustment.

The parties dispute whether Mercury's losses over a several-day period in December 2010 rise to the level of a catastrophe. Inclusion of the December 2010 storm losses in Mercury's projected losses results in a higher overall indicated rate.[32]

a. Findings re: Catastrophic Loss

A preponderance of the evidence establishes the following facts regarding industry catastrophe definitions, historical rain losses and Mercury's December 2010 storm losses.

i. Industry Definitions of a Catastrophe

The Regulations do not define catastrophe or provide any guidance in this area. Consequently, insurers do not uniformly define catastrophic losses. In order to develop a

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[31] Exh. 10-2. References to the transcript of the hearing are "Tr." followed by the page number(s), and where line references are used, a ":" followed by the line number(s). For example, a reference to Tr. 35:14-18 is to page 35, lines 14-18 of the transcript. Exhibits are referred to by the numbers assigned to them in the Exhibit Lists filed by the parties.

[32] Tr. 498:9-14.

consistent catastrophe methodology, the ALJ considered the various methods employed by the insurance industry.

The Actuarial Standards Board issued Actuarial Standards of Practice (ASOP) No. 39 to guide actuaries who evaluate catastrophe exposure. In so doing, the ASB defined a catastrophe as "a relatively infrequent event or phenomenon that produces unusually large aggregate losses."[33] The ASB's definition emphasizes the frequency aspect of the loss as opposed to the amount of loss dollars or number of claims generated.[34]

Conversely, the Insurance Services Office's Property Claims Service (PCS) unit, a recognized authority on catastrophic losses, accentuates the amount of total loss to the industry. When a disaster strikes, PCS investigates the amount of damage suffered. For each catastrophe, PCS assigns a serial number that permits insurers to track losses and reserves related to a single, discrete event. PCS defines catastrophes as events that cause $25 million or more in industry-wide direct insured losses to property and that affect a significant number of policyholders and insurers.

A majority of Mercury's competitors define catastrophes in a manner similar to PCS's description. For example, State Farm codes losses as "catastrophic" if they result from a single event that produces at least 500 claims and $500,000 in anticipated indemnity payments within California.[35] Likewise, the California State Automobile Association designates losses amounting to $1 million with a significant number of

[33] Exh. 10-6.
[34] Exh. 10-16.
[35] Exh. 539.

claims as catastrophic in nature.[36] In addition, Farmers Insurance Group and Safeco employ a loss and claims count catastrophe characterization.[37]

Finally, the Casualty Actuarial Society defines a catastrophe as a natural or man-made disaster that is unusually severe and results in a significant number of claims. This can include hurricanes, tornadoes, hail storms, earthquakes, wildfires, winter storms, explosions, oil spills and certain terrorist attacks.[38]

ii. Mercury's Past Practice for Catastrophes

Historically, Mercury has not coded roof leak losses as a catastrophe regardless of loss or claim amount, as a matter of practice rather than written policy.[39]

A Mercury-provided chart demonstrates that for calendar years 2004 and 2005, Mercury sustained roof leak losses of $4.2 million and $7 million respectively. Roof leak losses for calendar year 2010 eclipsed years 2004 and 2005 combined, totaling more than $12.3 million in paid losses.[40] Despite these significant loss amounts, Mercury did not remove these roof leak losses in this, or previous, rate filings.

Mercury excluded losses related to catastrophic fire, wind, mold and flood events nearly each year for the past 20 years.[41] For example, Mercury suffered catastrophic wind losses every year from 1998 to 2010. These losses ranged from $3,000 in 2001 and 2005 to $2.7 million in 2003, with a majority of the losses falling under $80,000. As to mold losses, Mercury removed between $7,000 and $96,000 from 2001 and 2010. Notably, Mercury also suffered catastrophic fire losses nearly every year since 2003. Fire losses range from $5,000 in 2004 to $16.2 million in 2003.

[36] Tr. 1234-35:21-2.
[37] Tr. 488:5-10.
[38] Werner & Modlin, Basic Ratemaking (Casualty Actuarial Society 2010) pp. 97-98.
[39] Gao Pre-Filed Direct Testimony (PDT), 12:20-21; Tr. 447:8-25.
[40] Exh. 60.
[41] Exh. 48-29.

Mercury did not link these prior excluded catastrophic losses to PCS catastrophe designations. In fact, it is impossible to trace many of Mercury's catastrophic losses to a PCS catastrophe, because Mercury reported catastrophic losses in years where no PCS designation was made. For example, in calendar years 1999, 2000, 2001, 2006 and 2009, Mercury reported catastrophic fire, wind and mold losses. But, an examination of PCS code designation for California reveals PCS did not designate a catastrophe in any of those years.[42] Similarly, in 2008 Mercury reported $10.6 million in catastrophic fire losses, although PCS did not designate a wildfire catastrophe in that year.

iii. December 2010 Winter Storms

In late December 2010, a series of severe winter storms swept through California dropping record amounts of rain and snow throughout the state. Beginning on December 17, large portions of the State saw more than one inch of rain fall in a two-day period, with many locations seeing well over two inches of rain in 48 hours. Wind gusts reached 100 miles per hour in the Tahoe National Forest, and 90 miles per hour in Yosemite National Park. This was but the first "car" of a train of Pacific storms that continued to inundate California for the next several days.[43] As of December 23, 2010, when the storms subsided, the central Sierra Nevada mountains recorded 17 feet of snowfall during the six-day period, with nine feet of snowfall in the eastern Sierras and eight feet of snowfall recorded in the northern Sierras.[44] Rainfall totals reached more than 20 inches in central California with 12 inches falling in Santa Barbara, and 16 inches falling in Kern and Tulare Counties. Wind gusts measured on December 22, 2010 reached over 60 miles an hour throughout the state.

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[42] Exh. 91.
[43] Exh. 62-2.
[44] Exh. 62-3.

On December 22, 2010, PCS issued Catastrophe Bulletin No. 34 in response to the December 2010 winter storms. Selecting the catastrophe dates as December 17 through December 22, 2010, PCS noted the series of Pacific storms caused record rain and snowfall in California and resulted in severe flooding and mudslides for portions of southern California. Although the brunt of storms exited the State on December 22, 2010, PCS noted that rivers and streams would rise further, threatening roadways, bridges and homes.[45] The National Weather Service similarly tracked the winter storms, noting that from December 16 through December 23, 2010, precipitation amounts at certain locations surpassed annual average totals.[46]

On January 26, 2011, the federal government determined that the damage caused by the severe winter storms, flooding, debris and mud flows during the period of December 17, 2010 to January 4, 2011, was of sufficient severity and magnitude to warrant a major disaster declaration.[47] Similarly, California's Governor declared a State of Emergency in 12 California counties as a result of the winter storms.[48]

iv. Mercury's December 2010 Storm Losses

As a result of the December 2010 winter storms, Mercury's roof leak claims and losses increased. In December 2010, Mercury reported 1,806 roof leak claims, totaling more than $7.1 million in losses. The number of roof leak claims reported in December 2010 is larger than the total number of roof leak claims received by Mercury during calendar years 2008 and 2009 combined.[49] In fact, Mercury's 1,806 roof leak claims in

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[45] Exh. 62-4.
[46] *California Storm Summary December 16-23, 2010*, National Weather Service <http://www.cnrfc.noaa.gov/storm_summaries/dec2010storms.php > (as of Apr. 19, 2012).
[47] California; Major Disaster, 76 Fed. Reg. 6809-01 (Feb. 8, 2011).
[48] Governor's Exec. Order No. S-18-10 (Dec. 31, 2010).
[49] Exh. 51-2.

December 2010 are higher than the calendar year roof leak claim totals for all but one year in the last nine years.

Similarly, the total losses for roof leak claims in December 2010 are greater than the total amount of roof leak losses during calendar years 2007 through 2009 combined. Prior to the December 2010 losses of over $7 million, the largest single month roof leak loss occurred in January 2005 when Mercury reported $3.3 million in losses.[50] What is more, the December 2010 roof leak losses totaled 57% of all roof leak losses in the 2010 calendar year.[51]

During the eight-day period between December 17 through December 24, 2010, Mercury received 1,464 roof leak claims, amounting to more than 80% of the roof leak claims reported in December 2010, and 42% of roof leak claims for the calendar year.[52] The number of roof leak claims received during this one week surpassed the annual roof leak claims received by Mercury in all but one year since 2003.[53] In addition, the total roof leak losses for this time period equaled more than $5.8 million. With the exception of 2005's annual roof leak losses of $6.9 million, the roof leak losses suffered during those eight days is greater than the annual roof leak losses of any year since 2003.[54]

While a substantial portion of Mercury's losses during December 2010 resulted from roof leaks, Mercury policyholders also suffered additional types of loss as a result of the winter storms. For instance, from December 19 through December 22, 2010, Mercury suffered losses of $412,561 resulting from trees falling on homes.[55] Mercury also reported losses of $279,683 from ground water damage during the winter storm, and

[50] Exh. 60.
[51] 7,114,983/12,356,893 = .5757.
[52] Exh. 538-1; 1,464/1,806 = .810; 1,464/3,490 = .419.
[53] Exh. 51-2.
[54] Exh. 51-1.
[55] Exh. 430.

$48,114 in fence damage as a result of wind gusts. More significantly, Mercury reported $1 million in unexplained "water damage – other" losses during the rain event.[56]

v. Mercury's Statements Re: December 2010 Storm

Mercury made a number of public and private statements with regard to the impact of the December 2010 winter storms. For instance, Mercury's 2010 Annual Report states its net income "was negatively impacted by catastrophic rainstorms in California" resulting in approximately $25 million in losses.[57] The Annual Report notes the event's significant impact on Mercury's finances:

> In December 2010, the Insurance Services Office officially designated California winter storms occurring between December 17, 2010 and December 22, 2010 as a catastrophe. These storms established precipitation records across the state with some mountain areas receiving over 200 inches of snow and many lower elevation locations receiving in excess of 15 inches of rain. The Company experienced a large increase in homeowners and automobile claims as a result of these storms. The Company estimates that total losses from these storms are approximately $25 million.[58]

Similarly, Mercury's consolidated financial statements identify pre-tax catastrophe losses of $25 million from heavy California rainstorms.[59]

On three separate occasions, Mercury informed the CDI that wind and heavy rains occurring between December 17 and 22 contributed to a spike in number of claims and losses reported in the fourth quarter of 2010.[60] As Mercury stated, "this rogue event is well documented by PCS Catastrophe Serial No. 34." In addition, Mercury also stated

[56] Exh. 440.
[57] Exh. 505-8.
[58] Exh. 505-11.
[59] Exh. 505-12.
[60] Exh. 522-10 through 522-12.

"the increase was primarily due to increasing loss frequency that was compounded by catastrophic rainstorms in California that occurred in the fourth quarter of 2010."[61]

Mercury's Incurred But Not Reported (IBNR) loss reports for its California homeowners line also identify the December 2010 winter storms as catastrophic. IBNR refers to claims not yet known to the insurer, but for which a liability is believed to exist at the reserving date. IBNR loss documents represent an important part of an insurer's accounting machinery. An inaccurate IBNR reserve report may lead to inexact management decisions. More than that, California law requires accurate and appropriate IBNR reserves. Insurance Code section 923.5 provides that each insurer shall at all times maintain reserves in an amount estimated to provide for payment of all losses and claims.[62] California further requires verification of adequate loss reserves in the form of an annual Statement of Actuarial Opinion.

Mercury provided the parties with a report titled "IBNR California Catastrophe Report" for the first three quarters of 2011. Each of Mercury's IBNR reports isolates paid losses and case reserves for an event classified as "2010 CAT 12/20 – 12/25" as well as other catastrophic events in 2008, 2007 and 2003.[63] The three reports, each with a different valuation date, note significant wind and auto losses from the December 2010 winter storms.

b. Mercury's Proposed Analysis

Mercury contends its catastrophe definition is in keeping with ASOP 39 with regard to frequency, severity and consistency principles. Mercury also argues the CDI

[61] Exh. 522-9.
[62] Cal. Code Regs., tit. 10, § 2319 – 2319.4.
[63] Exh. 538-3 through 538-5. These exhibits are conditionally filed under seal.

tacitly approved the rain loss exemption in prior rate filings and as such is estopped from requiring Mercury to alter its catastrophe definition at this juncture.

i. Frequency

Mercury claims its catastrophe definition conforms to ASOP 39's characterization of a catastrophe as a "relatively infrequent event or phenomenon that produces unusually large aggregate losses."[64] In so concluding, Mercury relies in part on the frequency of Mercury's roof leak losses. The insurer notes that roof leak losses occurred nearly every month since 2003, thus are not infrequent events.[65] In fact, Ms. Bass opines that a catastrophe under ASOP 39 cannot be an event that happens every year or every other year.[66]

ii. Severity

Mercury further argues the impact of the Mercury's December 2010 rain losses is insignificant when compared to Mercury's overall book of business and calendar year losses.[67] Mercury relies on a loss ratio assessment in support of this conclusion.[68] For instance, Mercury's December 2010 paid roof leak losses were approximately 6.1% of Mercury's direct earned premium for 2010, while the average roof leak loss ratio equals 2.4%.[69] And because this difference in loss ratio is small, Mercury concludes the 2010 storm losses do not distort Mercury's loss experience to the level required to call the

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[64] Bass PDT, 26:10-12.
[65] *Id.* at 26:20-23.
[66] Tr. 199-200:17-7.
[67] Mercury's Post-Hearing Opening Brief, 13:7-11.
[68] Loss ratio is a measure of the portion of each premium dollar used to pay losses and is calculated as: Loss ratio = Losses/Premium. For example, if the total loss dollars are $300,000,000 and the total premium is $400,000,000, then the loss ratio is 75% (= $300,000,000 / $400,000,000).
[69] Mercury's Post-Hearing Opening Brief, 15:6-13.

event a catastrophe.[70] Indeed, Ms. Bass would not classify an event a catastrophe unless the loss ratio was 25-50% higher than the average loss ratio.[71]

Mercury also contends ASOP 39's definition of catastrophe implicitly requires actuaries to employ a loss ratio method in determining whether an event is a catastrophe.[72] It is undisputed that ASOP 39 is silent with regard to loss ratios or any other formulaic approach to defining catastrophes.[73] Yet, Mercury states ASOP 39 mandates a loss ratio analysis. Mercury makes this claim despite being unable to name another insurer using this method.[74]

Alternatively, Mercury states the proper method of evaluating the December 2010 rain losses is to consider the "rainy season" as a whole.[75] Defining the rainy season as a four-month period from December to March, Mercury notes 2010-2011 rainy season roof leak losses totaled nearly $10 million as compared to rainy season roof leak losses of $7.19 million in 2004-2005; an insignificant disparity in Mercury's opinion.[76] Similarly, Mercury analyzed rainy season loss ratios and concluded the difference between yearly loss ratios to be trivial. Mercury states roof leak losses for 2005 amounted to a 4.3% loss ratio, while 2010 roof leak losses equaled 5.9% of premium. Mercury thus concludes the distortion is insignificant under this method as well.

iii. Consistency

Mercury also asserts that the actuarial principle of consistency requires Mercury to include roof leak losses in its calculation of projected losses. ASOP 39 suggests an

[70] *Id.* at 15:14-22; Bass Pre-filed Additional Direct Testimony (PADT), 7:7-11.
[71] Tr. 215:14-18; Tr. 216:6-13.
[72] Mercury's Post-Hearing Opening Brief, 13:12-19.
[73] Tr. 381:12-21.
[74] Tr. 488:15-19.
[75] Mercury's Post-Hearing Opening Brief, 14:11-15:5.
[76] *Id.* at 15:1-5; Bass PADT, 8:1-5.

actuary consider the consistency of the thresholds used to determine catastrophic losses. Because Mercury has never considered roof leak losses to be catastrophic, Mercury contends altering its procedure now would introduce bias into the ratemaking system.[77] Mercury also relies on the consistency standard to conclude that designating the December 2010 storm event as a catastrophe will require Mercury to reexamine all prior rain events.[78]

Lastly, Mercury argues the CDI's failure to criticize Mercury's exclusion of roof leak losses in previous approved rate filings prevents the CDI from now raising the issue. Mercury notes that the Department approved the 2008 rate filing, which included significant rain losses from 2005. Because the CDI did not object to the 2005 rain losses remaining in the projected loss calculation, Mercury concludes the Department granted it license to exclude roof leak losses from its catastrophe definition.[79]

c. CDI's Proposed Analysis

The CDI does not endorse a specific definition of "catastrophe" nor does it advocate for a loss and claim count approach to catastrophe classification. Instead, the Department simply defines a catastrophe as an event that causes a significant distortion in the loss ratio during the rating period.[80] That is, the CDI argues one should analyze the historical annual and quarterly loss ratios for significant fluctuations. A substantial variation between loss ratios warrants further consideration and may signal a catastrophic

[77] Mercury's Post-Hearing Opening Brief, 10:2-13:2.
[78] *Ibid.*
[79] *Id.* at 11:11-13.
[80] CDI's Post-Hearing Opening Brief, 5:18-23.

event.[81] An insurer's actual catastrophe definition is immaterial providing the insurer removes catastrophic losses in accordance with the Regulations.[82]

While the CDI finds a catastrophe classification from PCS relevant as it demonstrates industry opinion, designation by PCS is not controlling. Nor does the length or type of event govern.[83] The CDI argues a catastrophe designation does not turn on whether the event was a one-day earthquake or a nine-day rainstorm. Instead, the determining factor must be the distorting effect on the loss ratio. Likewise, the CDI finds the cause of the event irrelevant.[84] A catastrophe designation does not depend on whether the event is a natural disaster or a man-made event, but instead upon the distorting nature of the peril. Further, the CDI is not aware of any other insurers that exclude certain types of loss, such as roof leak losses, from their catastrophe definition. In fact, the CDI notes that other insurers specifically removed the December 2010 rain losses, including roof leaks, from their projected loss calculations.[85]

i. Annual Loss Ratio

Unlike Mercury, who calculated roof leak loss ratios only, the CDI examined Mercury's annual and quarterly ultimate loss ratios to determine the impact of the December 2010 event. Using an annual year ending on September 30, 2011, the CDI concluded that Mercury's ultimate loss ratio equaled 52.8%; a 9.4% increase over the prior year's loss ratio.[86] In fact, on only one occasion since 2003 had Mercury's annual loss ratio increased so drastically. That loss ratio increase of 14.6% occurred in the year ending September 30, 2005, and coincided with PCS Catastrophe Bulletin No. 80,

[81] *Id.* at 5:21-23.
[82] Tr. 1142:3-7; Tr. 1237:21-25.
[83] CDI's Post-Hearing Opening Brief, 9:23-25.
[84] *Id.* at 9:18-22.
[85] *Id.* at 10:5-9.
[86] CDI's Post-Hearing Reply Brief, 6:6-22; Exh. 436.

another thunderstorm and wind event.[87] The Department also calculated Mercury's five year average loss ratio and compared it with the loss ratio for the year ending September 30, 2011. This comparison noted Mercury's five year average ultimate loss ratio equaled 45.9%; 6.9% lower than the 2011 loss ratio of 52.8%.

ii. Quarterly Loss Ratio

The CDI further contends that Mercury's quarterly loss ratio illustrates the impact of the December 2010 event on the ultimate annual loss ratios.[88] For example, the fourth quarter 2010 loss ratio of 66.6% caused the rolling four quarter loss ratio to dramatically increase from 43.4% to 50.2%. Put differently, from October 1, 2009 through September 30, 2010, the ultimate loss ratio equaled 43.4%. But when one rolls the data forward one quarter, from January 1, 2010 through December 31, 2010, the ultimate loss ratio surges to 50.2%, despite having six months in common.[89] On only one prior occasion has Mercury suffered such an extreme rise in the rolling four quarter loss ratio; the first quarter of 2005 during the severe winter storm discussed in the preceding paragraph. Excluding 2005's first quarter, the 2010 fourth quarter loss ratio is more than 11 percentage points higher than any other quarterly loss ratio. The Department concludes this drastic rise in the loss ratio demonstrates the distorting impact of the December 2010 rain event.[90]

d. Consumer Watchdog's Proposed Analysis

Consumer Watchdog argues Mercury's losses from the December 2010 winter storms constitute catastrophic losses that must be removed from Mercury's projected

[87] Exh. 91-2.
[88] CDI's Post-Hearing Opening Brief, 6:17-22.
[89] Exh. 437; Exh. 95-2.
[90] CDI's Post-Hearing Reply Brief, 10:11-11:14.

losses. In support of this contention, Consumer Watchdog relies upon Mercury's own statements and Mercury's significant December 2010 losses.

i. Mercury's Public Statements

Consumer Watchdog notes that prior to the commencement of this hearing, Mercury referred to the December 2010 winter storms as catastrophic in rate-filing documents and shareholder reports.[91] Consumer Watchdog also notes that given Mercury's consistent description of the December 2010 winter storms as catastrophic, any argument otherwise is simply disingenuous. In fact, Consumer Watchdog likens Mercury's denial to a prior inconsistent statement that impacts Mercury's credibility.[92]

ii. Severity of Losses

Like the CDI, Consumer Watchdog also urges the Commissioner to consider the substantial losses incurred by Mercury during the December 2010 rain storm. Whereas, Mercury's witnesses assert the total losses do not reach catastrophe level, Consumer Watchdog notes the over $5.2 million in roof leak losses is significant when compared to past events classified as catastrophes by Mercury.[93] From 1990 through 2010, Mercury reported 32 historical catastrophe values. Only three of those had values greater than the December 2010 rain storm losses. In fact, 25 of the 32 catastrophe loss values totaled $80,000 or less.[94] And, while Consumer Watchdog rejects Mercury's methodology in comparing roof leak losses to the annual loss ratio, it notes the deviation between Mercury's roof leak losses is considerably larger than the deviations between Mercury's

[91] Consumer Watchdog's Post-Hearing Opening Brief, 10:20-11:5.
[92] Consumer Watchdog's Post-Hearing Reply Brief, 1:15-16.
[93] Consumer Watchdog's Post-Hearing Opening Brief, 11:7-12:13.
[94] Exh. 48-29.

liability losses.[95] For example, the highest annual roof leak loss ratio is more than eight times greater than the lowest annual roof leak loss ratio.[96] By contrast, the range from highest to lowest annual liability loss ratio is less than three times greater.[97]

e. Analysis and Conclusions re: December 2010 Storm Losses

The Commissioner generally reviews catastrophic events on a case-by-case basis. Indeed, the Regulations themselves eschew a finite description, and any attempt to provide an absolute meaning would be contrary to regulatory intent. But the ALJ should consider certain factors when determining whether a particular event or series of events rises to the level of a catastrophe. Those factors include (i) PCS designation, (ii) severity of losses, (iii) impact on loss ratio, (iv) a party's own statements and (v) the effect of the event on the overall rate template.[98]

The objective behind removal of catastrophe losses serves as an excellent analytical starting point. Rate makers typically remove catastrophic losses to avoid their distorting effects in any ratemaking analysis. Without removal of catastrophe losses, indicated rates will increase immediately after a bad storm year and decrease in years when no or few storms occur. Thus, it is helpful to consider the distortionary impact when identifying catastrophic events. Put differently, examination of damage and claim amounts, as well as annual and quarterly loss ratios, is a necessary step in determining a catastrophic event. Applying these five factors to the facts in this case, the ALJ concludes the December 2010 storm losses were catastrophic.

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[95] Consumer Watchdog's Post-Hearing Reply Brief, 6:9-22.
[96] Exh. 60; 6.1%/.07% = 8.7.
[97] Exh. 18-1; 3.8%/1.5% = 2.5.
[98] The Commissioner need not render an opinion regarding Mercury's past roof leak losses, since such findings are outside the scope of this proceeding.

i. PCS Designation Supports a Finding of Catastrophe

PCS, a nationally recognized authority in the classification of catastrophic losses, categorized the December 2010 rain storms as a catastrophe. This branding lends significant support to CDI and Consumer Watchdog's argument. Of course, PCS designation is not dispositive of the issue. In some cases, PCS may designate an event a catastrophe while a specific insurer may have suffered only minor losses. In those instances, PCS designation would not be determinative. But absent such a circumstance, as in this case, the ALJ concludes PCS's designation provides support to the classification of catastrophic losses.

Even Mercury concedes PCS's designation of the December 2010 rainstorms as catastrophic is significant. Mercury asserted throughout this litigation that, with the exception of rain losses, it codes a loss as "catastrophic" if PCS assigns the event a catastrophe code.[99]

ii. Severity of Losses Supports a Catastrophe Designation

Mercury's claim numbers and loss amounts from December 2010 offer further proof of the distortionary impact of the December 2010 winter storms. From December 17 through December 24, 2010, Mercury received 1,464 roof leak claims, equaling 42% of Mercury's annual roof leak claims. In fact, the number of roof leak claims received during that one week period surpassed the annual number of roof leak claims in all but one year since 2003. Similarly, roof leak losses totaled $5.8 million during those eight days; an amount greater than Mercury's annual roof leak losses in each of the last 10

[99] Exh. 522-22; Tr. 170:11-17.

years, with the exception of 2005. These amounts establish the significant impact the December 2010 event had on Mercury Casualty.

Both Ms. Gao and Ms. Bass testified the December 2010 storm event resulted in trivial losses to Mercury's book of business rendering removal of the $5.8 million in roof leak losses unnecessary. But their testimony is inconsistent with Mercury's past practice of removing small catastrophic losses. Of the 32 events Mercury classified as catastrophic in the past two decades, only seven of those resulted in losses of more than $80,000. Mercury's witnesses fail to explain how miniscule losses such as those must be removed from projected loss totals, while $5.8 million in losses must be included.

A similar analysis extinguishes Mercury's frequency argument. Both Ms. Bass and Ms. Gao state that because roof leak losses occur every year, those losses cannot be found to be infrequent under ASOP 39. In fact, Ms. Bass concludes that an event occurring every other year cannot be considered infrequent. But Ms. Bass's opinion is not supported by the weight of the evidence. Mercury recorded catastrophic wind losses in each of the last 14 years and similarly recorded catastrophic fire losses every year since 2007. Ms. Gao explained this inconsistency as miscodes in the data.[100] The ALJ gives little weight to Ms. Gao's explanation and concludes that while the data may include some miscodes, it is implausible that nearly all the wind and fire losses over the last two decades were erroneously recorded.

iii. Loss Ratio Supports a Catastrophe Designation

The ALJ finds further evidence of the distortionary impact of the December 2010 winter storms when scrutinizing Mercury's ultimate loss ratios. Mercury's annual loss ratio from September 30, 2010 through September 30, 2011 totaled 52.8%; a 9.4%

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[100] Tr. 494:2-18.

increase over the prior year's loss ratio. Inspection of the rolling four quarter loss ratio produces a similar impact. From October 1, 2009 through September 30, 2010, the ultimate loss ratio equaled 43.4%. But when one rolls the data forward one quarter, from January 1, 2010 through December 31, 2010, the ultimate loss ratio surges to 50.2%, despite having six months in common. Also significant is Mercury's fourth quarter 2010 loss ratio of 66%; Mercury's second highest quarterly loss ratio since 2003 and more than 20 percentage points higher than 2009's fourth quarter loss ratio.

Mercury urges the Commissioner to consider only the roof leak loss ratio or the rainy season loss ratio in evaluating the change in loss ratios. But the ALJ finds Mercury provides no actuarial support for those positions. Catastrophes are not analyzed based on their impact over an entire rainy season nor are damages limited by type of loss suffered. Such an analysis serves only to obscure the distortionary impact of the December 2010 storms.

iv. Mercury's Statements Support Designation

Mercury's own statements to the CDI and its shareholders concede the catastrophic nature of the December 2010 rain event. On three separate occasions, Mercury presented documents to the CDI identifying the December 2010 rain storm as a catastrophic event. These statements, coupled with the more than four instances in Mercury's Annual Report when it classifies the December 2010 winter storm as a catastrophe, leads one to conclude that even Mercury believed the event to be catastrophic. In addition, Mercury did not alter its definition and characterization of the December 2010 event until after the losses became an issue in this litigation. Thus, while

Mercury would have the Commissioner ignore Mercury's public statements,[101] the ALJ finds these statements relevant since they provide Mercury's initial assessment of the December 2010 event.

v. Impact on Rate Template Supports Designation

The ALJ finds the strongest support for catastrophic designation in the December 2010 event's distortionary impact on the rate template. Comparing Mercury's rate template, which did not exclude catastrophic losses, to that provided by the CDI, which excluded a portion of the December 2010 losses, reveals a nearly 5 percentage point change in the indicated rate; the difference between a rate increase and a rate decrease.[102] Indeed, if the December 2010 winter storms had little impact on Mercury's loss ratio, one would expect the parties' rate templates to be within a small range. But that is far from the case. Given the large distortion in the indicated rate caused by the December 2010 rain event, any claim of insignificance regarding the December 2010 losses is not plausible.

vi. Past Rate Applications Irrelevant to Designation

The ALJ finds no merit to Mercury's claim of tacit approval for its catastrophe definition. Mercury claims the CDI's prior acceptance of Mercury's rate applications constitutes binding acceptance of Mercury's decision to ignore catastrophic roof leak losses. Notwithstanding the large amount of testimony and argument directed at this issue, Mercury's position is misguided. Regulation section 2656.4, subdivision (c), specifically provides that the Commissioner's approval of a rate, without a hearing and findings of fact, does not constitute approval or precedent regarding any principle or issue

[101] Gao PADT, 7:21-28.
[102] Exh. 336; Exh. 48-35.

in any other proceeding. Thus, by approving Mercury's 2008 homeowner's rate application without a hearing or findings of fact, the Commissioner did not approve Mercury's catastrophe definition or any other principle at issue therein.

Mercury also argues that because it has never considered roof leak losses to be catastrophic, to alter that procedure now would introduce bias into the ratemaking system. Mercury's past practice is neither consistent with the Regulations nor actuarially sound. The Regulations require removal of all catastrophic losses and do not permit an insurer to pick and choose the types of peril it wishes to consider disastrous. That no other insurer excludes rain losses from catastrophic designation demonstrates the potential for abuse. If Mercury is permitted to include significant December 2010 losses in its projected losses, while all other insurers exclude such losses, the ALJ concludes Mercury would receive a substantial unfair advantage that is contrary to regulatory intent. Likewise, while actuarial principles favor consistency, ASOP 39 makes clear that such principles must yield to regulatory conflicts.[103]

vii. Conclusion

Based on the overwhelming evidence demonstrating the distortionary effect of the December 2010 storm on Mercury's projected losses and indicated rate, the ALJ concludes the December 2010 winter storms to be "catastrophic" under the Regulations. As such, the catastrophic losses must be removed from Mercury's projected losses.

2. Amount of Non-Modeled Catastrophic Losses to be Excluded

The parties also disagree on the correct amount of losses to be excluded as catastrophic. The CDI suggests removing $6.9 million from Mercury's historic losses,

[103] Exh. 10-9.

while Consumer Watchdog argues the correct amount totals $7.6 million. Mercury disagrees with both calculations but does not suggest a credible alternative amount.

a. Findings re: Non-Modeled Catastrophic Losses

The ALJ finds by a preponderance of evidence the following facts regarding Mercury's December 2010 winter storm losses.

In December 2010, Mercury reported 1,806 roof leaks claims, totaling more than $7.1 million in losses. During the eight-day period between December 17 through December 24, 2010, Mercury received 1,464 roof leak claims, amounting to more than 80% of the December 2010 roof leak losses.[104] During that same time period, Mercury suffered losses of $279,683 from ground water damage and $544,000 in wind damage. In addition, Mercury experienced $1 million in unexplained "water damage."[105] Policy form HO-3 suffered 99% of the losses during this event.[106]

Mercury's IBNR report dated September 30, 2011 indicates Mercury experienced losses totaling $7,509,867 as a result of the December 2010 rain event. The September 2011 IBNR report also states Mercury's case incurred losses for the December 2010 rain event totaled $7,529,928.[107]

However, Mercury failed to present any evidence to distinguish how much of the above losses are directly the result of the December 2010 storms. At no time during direct or rebuttal testimony did Mercury calculate losses incurred from the December 2010 winter storm. When questioned about this omission, Mercury's witnesses indicated such a presentation would require Mercury to review and code its loss data for the past 17

[104] Exh. 430.
[105] Exh. 440.
[106] Exh. 119.
[107] Exh. 538-3 through 538-5. This exhibit is conditionally filed under seal pursuant to the parties Stipulated Protective Order.

years.[108] In an effort to provide Mercury one last opportunity to support its contentions, the ALJ ordered Mercury to provide the monetary value for all homeowner's losses incurred by Mercury Casualty as a result of the late December 2010 winter storms.

In response, Mercury provided monetary values that were admittedly of questionable accuracy, since Mercury did not examine the claim files to determine whether the losses resulted from the December 2010 event.[109] Instead, Mercury simply restated roof leak loss amounts the ALJ already possessed, noting the totals for various end dates.

b. Mercury's Contentions

Mercury calculates its December 2010 catastrophic losses at $4,908,041; the total amount of roof leak losses from December 17 through December 22, 2010.[110] Mercury argues that only roof leak losses may be treated as catastrophic because only roof leak losses had a distortive impact on Mercury's loss ratio.

Mercury also contends wind and ground water losses must remain outside the catastrophic loss calculation since these losses, looked at in isolation, do not have a distortive effect on the loss ratio.[111] In addition, Mercury argues there is no evidence that wind and ground water damage resulted from the December 2010 winter storms. Mercury contends the losses could be the result of any number of events.[112]

Mercury further asserts the Commissioner should rely upon the PCS dates when calculating catastrophic losses.[113] Mercury notes that while PCS identified the catastrophic event as commencing on December 17, 2010, the CDI began its analysis of

[108] Tr. 1995:5-18.
[109] Gao Testimony in Response to ALJ's April 11, 2012, Order (Gao ALJT), 2:16-18.
[110] Mercury's Post-Hearing Opening Brief, 24:21-26.
[111] *Id.* at 25:13-21.
[112] *Id.* at 26:18-27.
[113] *Id.* at 25:4-12.

excluded losses on December 16, 2010. The use of a December 16 start date results in $330,653 in additional excluded losses. Mercury also claims the CDI's inclusion of losses from December 23 and December 24, 2010 is inappropriate, since the catastrophic event ended on December 22, 2010. Instead, Mercury concludes only 50% of the losses from December 23 and December 24 should be excluded because the CDI did not provide evidence that losses on those dates stemmed from the catastrophic event.[114]

Mercury also challenges Consumer Watchdog's manner of calculating December 2010 rain losses. Mercury states that reliance upon on the actuarial reserve report is misplaced, since Mercury did not review the document during the ratemaking process.[115] In addition, Mercury notes the IBNR report data is inconsistent with the data provided in its rate application, thereby proving the reserve report unreliable.[116]

Lastly, Mercury argues that some of the December 17 through December 24 losses were normal, non-catastrophic losses and thus should not be included in the calculation of catastrophic losses.[117] In order to account for this "practical reality," Mercury reduced the amount of catastrophic losses by the average daily rain losses that occurred from December 17 through December 24 in years 2007, 2008 and 2009. Again, Mercury did not examine its claim files to determine the cause of the ground water claims during the December 2010 winter storms.[118]

c. CDI's Contentions

The CDI argues that because the majority of losses occurred from December 16 through December 24, 2010, the Commissioner should apply those dates in calculating

[114] Bass Pre-Filed Rebuttal Testimony (PRT), 11:5-15.
[115] Mercury's Post-Hearing Opening Brief, 29:5-10.
[116] *Id.* at 29:21-30:8.
[117] *Id.* at 27:18-23.
[118] Gao ALJT, 3:9-18.

the amount of catastrophic losses.[119] By the CDI's calculation, at least $6,969,643 must be removed from Mercury's projected losses. This total includes storm-related losses such as falling trees and flying object damage as well as $6.1 million in roof leak losses.[120] The CDI considers its estimate to be at the lower boundary of total catastrophic losses for December 2010 and believes the true amount could be significantly higher. Indeed, the CDI did not include in its calculation the $1 million in unexplained "water damage – other" losses experienced during the rain event.[121]

The CDI also rejects Mercury's claim that "normal" losses must be removed from the catastrophe calculation. The CDI notes such an approach is inconsistent with Mercury's past practice in removing all catastrophic losses.[122]

d. Consumer Watchdog's Contentions

Consumer Watchdog employs a different method in computing the amount of losses to be excluded. The Intervenor relies entirely upon Mercury Casualty's IBNR reserve reports discussed above. Thus, Consumer Watchdog urges the Commissioner to remove $7,529,928 in catastrophic losses.[123]

e. Analysis and Conclusions re: Amount of Catastrophic Losses to be Excluded

Having considered both the undisputed facts and legal arguments raised by the parties, the ALJ concludes that no less than $7,529,928 must be removed as catastrophic losses from the December 2010 winter storms based on the following analysis. The entire amount shall be removed from the HO-3 form as discussed below.

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[119] CDI's Post-Hearing Opening Brief, 12:1-9.
[120] *Id.* at 15:8-28.
[121] *Id.* at 13:4-12.
[122] *Id.* at 14:21-15:5.
[123] Consumer Watchdog's Post-Hearing Opening Brief, 13:8-23.

i. Losses Occurring from December 17 through December 25 Must be Included in Calculation

Mercury contends the Commissioner should remove only those losses occurring from December 17 through December 22, 2010, which coincides with the PCS catastrophe dates. While the ALJ agrees that losses occurring prior to December 17 must be excluded from the calculation, the ALJ rejects Mercury's asserted end date as it fails to account for what are clearly storm-related damages reported after December 22, 2010.

After examining the PCS and weather reports as well as claim and loss information, the ALJ concludes the catastrophic event did not begin until December 17, 2010. Though Mercury reported roof leak losses of $330,563 on December 16, 2010, the heaviest rain and wind did not arise until December 17, 2010. This finding corresponds with the PCS start date and Mercury's arguments. In addition, Mercury's data shows that a single homeowner's claim from December 16 resulted in losses of $291,610. It follows then that Mercury did not see an increase in claims and losses until December 17, 2010. Accordingly, the ALJ concludes that losses prior to December 17, 2010 should not be included in the catastrophe loss total.

PCS Catastrophe Bulletin No. 34 determined the catastrophic rain event concluded on December 22, 2010. But, contrary to Mercury's assertion that the PCS dates must be followed, a catastrophic event ends when significant losses arising from the event cease. Evidence demonstrates Mercury suffered substantial losses on December 23, December 24 and December 25, 2010 as a result of the catastrophic storms that took place during the holiday period. For example, Mercury coded more than $1 million in roof leak losses from December 23 through December 25, 2010, and another $300,000 in wind and water damage during that same time period, although heavy rains ended on

December 23, 2010. In response to this evidence, Mercury simply states it codes its claim information based on the loss date. But Mercury does not explain how it determined the loss date for claims reported days after the event ended. The ALJ concludes, absent any evidence to the contrary, that these losses are reasonably related to the winter storm. Given Mercury's substantial losses from December 23 through December 25, 2010, the ALJ concludes losses reported during that time period resulted from the December 2010 rain event.

ii. Roof Leak, Water and Wind Losses Must be Included in Calculation

The ALJ also concludes that roof leak damages suffered during the applicable time period resulted from the catastrophic rain storm. Indeed, Mercury concedes that a large portion of the $5,929,326 in roof leak losses must be included in the calculation. But the parties disagree on whether to include other storm-related damages in the damage calculation. Both CDI and Consumer Watchdog conclude rain-related damages must include rain, wind and ground water damage. Conversely, Mercury attributes only a portion of the damages suffered from December 17 through December 25, 2010 to the storm event.

Before reviewing the types of loss suffered, it bears noting that Mercury failed to provide the parties and the ALJ with a definitive calculation of catastrophe-related damages. Only Mercury possesses the claims files and data necessary to determine the causation for each claim. But rather than examine the claim files as ordered by the judge, Mercury chose instead to attack the loss amounts provided by CDI and Consumer Watchdog. Granted review of some 1,500 claims is time consuming. Yet Mercury had over one year to review these claims. In neglecting to review its claims or calculations prior to this proceeding, and in refusing to do so after the ALJ's Order, Mercury failed to meet its burden of proof.

It is undisputed that, from December 17 through December 25, 2010, Mercury recorded ground water damages totaling $279,683. Mercury claims this damage "possibly" resulted from non-rain related events such as broken plumbing or defective drainage. But examination of Mercury's generic claims information demonstrates quite the opposite. First, the only ground water claims recorded by Mercury during the fourth quarter of 2010 occurred during the catastrophic rain event.[124] In addition, Mercury specifically codes plumbing defects and sewer backups separately from ground water claims.[125] Accordingly, it is reasonable to conclude that ground water damage suffered from December 17 through December 25, 2010 resulted from the catastrophic storm event.

It is also undisputed that Mercury recorded wind damages equaling $565,810 from December 17 through December 25. Mercury believes wind damages should not be considered storm losses because "even if an area is simultaneously subject to high winds and rain, it is possible that one peril and not the other caused the loss." While it is certainly true that there can be high winds with or without rain, it is unclear why Mercury makes such a distinction in this instance. The PCS Catastrophe Bulletin for the December 2010 winter storms categorized the event as a "Wind and Thunderstorm Event" and noted that winds gusted from 46 to 100 miles per hour during the storm.[126] And examination of daily wind damage from the fourth quarter of 2010 shows a marked increase in wind

[124] Exh. 438. Mercury recorded one additional ground water claim on October 6, 2010 resulting in a loss of $1,823.
[125] See, Exhs. 349, 355 and 357.
[126] Exh. 62-1.

damage losses during the December 2010 rain storm.[127] Thus, it is reasonable to conclude that wind damages suffered during the relevant time period, be they fence, tree or structure damage, resulted from the substantial winds that accompanied the December 2010 winter storms.

Mercury contends its December 2010 wind losses of $565,810 is not a catastrophic loss because it is insignificant and does not have a distortionary impact on the loss ratio. This is a curious argument given that during the past 15 years Mercury recorded, as catastrophic, wind losses as small as $1,000.[128] In fact, 80% of wind losses categorized as catastrophic by Mercury resulted in losses of $80,000 or less. It follows then that Mercury's argument is not credible.

Finally, general loss data indicates that from December 17 through December 25, 2010, Mercury suffered "Water Damage – Other" losses totaling $1,002,138.[129] Though the ALJ ordered Mercury to calculate all catastrophe-related damages, Ms. Gao omitted these damages from her testimony and calculation. Despite Mercury's noncompliance with the ALJ's Order, the ALJ finds conclusions may be drawn from the data Mercury provided. Excluding the catastrophe dates, the average daily fourth quarter 2010 losses for the "Water Damage – Other" category equaled $54,055, while the average daily losses for this category during the catastrophic storms totaled $111,349.[130] In addition, the average claims count jumped from 5.82 daily claims to 15.11 daily claims during the December 2010 winter storms.[131] It is reasonable to conclude from data presented that these losses are not the result of plumbing overflows, sewer backups, and slab or

[127] Exh. 439.
[128] Exh. 48-29; Exh. 510.
[129] Exh. 440.
[130] *Ibid*; Gammell Additional Rebuttal Testimony in Response to Ms. Gao (ART), 4:23-25.
[131] Exh. 439.

appliance leaks since Mercury categorized those losses separately. Absent evidence to the contrary, given the increase in claims count and loss totals, the ALJ concludes Mercury's "Water Damage – Other" losses are related to the December 2010 storm and must be included in the calculation of catastrophic losses.

iii. Removal of "Normal" Losses Rejected

Mercury also argues that some "normal" non-catastrophic losses occurred during the relevant time period and such losses must be excluded from the ALJ's calculation. Mercury concludes the proper exclusion method requires removal of the average daily losses from 2007 through 2009. The ALJ finds Mercury's argument unpersuasive.

Mercury has the burden to demonstrate that certain claims and losses must be removed from the catastrophe calculation. Mercury had more than a year to demonstrate the CDI inadvertently included losses not related to the catastrophic winter storms. Had Mercury met this burden, it would not need to speculate on the amount of "normal" daily losses. Likewise, the Regulations do not permit an insurer to select a catastrophic loss amount it finds acceptable. Section 2644.4, subdivision (a) requires removal of the entire catastrophic loss, not some alternative amount above the "normal" daily loss. The ALJ concludes Mercury argument is unpersuasive and contrary to regulatory intent. To permit Mercury to remove some "normal" losses would introduce bias into the ratemaking template and violate actuarial standards.

iv. IBNR Report Confirms Calculation

Perhaps the most contentious evidence of catastrophic losses is found in Mercury's IBNR report. According to the IBNR report, as of September 30, 2011, Mercury's total losses incurred as a result of the December 2010 winter storms equaled

$7,585,951. Since Mercury generated the IBNR report, Consumer Watchdog argues it is the most accurate assessment of incurred losses. Conversely, Mercury argues its financial department generated the IBNR report without the expertise of any actuaries, thereby rendering the report defective. Further, Mercury argues the IBNR calculations for other catastrophic events are inconsistent with the calculations in Mercury's rate application. But Mercury's arguments fail to consider the legal significance of the IBNR report and ignore the implications resulting from apparent inaccuracies in Mercury's filings.

Regardless of which department creates an IBNR report, California law requires an accurate loss and reserve examination. Failure to provide an accurate report results in serious civil penalties.[132] Despite these penalties, Mercury claims its IBNR report is unreliable in the context of this administrative hearing. Mercury also points to the inconsistencies between Mercury's rate filing and its IBNR catastrophe reports in support of its argument. But Mercury's admissions are instead evidence of its substandard recordkeeping and careless supervision. Mercury does not explain the IBNR report's inconsistencies, nor does witness testimony demonstrate the accuracy of the rate filing calculation. Instead, Ms. Gao repeatedly testified that Mercury did not code the losses resulting from the December 2010 storm.[133] Yet the IBNR report contradicts this testimony because in generating the IBNR report, Mercury had to code its December 2010 storm losses.

Mercury also argues that the IBNR report overstates loss reserves resulting in an inaccurate calculation. But of the $7,529,928 in total losses, only $20,061 is a reserve

[132] Ins. Code § 924.
[133] Tr. 463:11-12; Gao ALJT, 2:17-18.

amount. The ALJ concludes that such a miniscule amount does not render the calculation unreliable nor does it impact the overall indicated rate.

A comparison between the IBNR calculation and totals generated by Mercury's loss data provides additional support for using the IBNR in calculating catastrophic losses. Losses from December 17 through December 25, 2010 totaled $7,776,957. Losses provided by the IBNR report equal $7,529,928. The resulting difference of $247,029 supports the probable accuracy of the IBNR report and likely provides for those December 17 through December 25 losses that were not the product of the catastrophic rain storm. Accordingly, the ALJ concludes Mercury must remove no less than $7,529,928 in catastrophic losses.

v. All Losses Removed from Policy Form HO-3

Having concluded that Mercury suffered catastrophic losses totaling at least $7,529,928, the ALJ must determine how to apportion those losses between policy forms. This decision is a simple one, as evidence demonstrates the entire amount may be removed from the HO-3 form.

Initially, Mercury's witnesses challenged Mr. Gammell's and Mr. Schwartz's decision to assign all December 2010 catastrophic losses to policy form HO-3, noting that such catastrophic losses may have impacted renters or condominium owners, as well as home owners.[134] But subsequent information provided by Ms. Gao alleviates this concern. In response to the ALJ Order, Mercury determined that HO-3 policyholders suffered more than 99% of the December 2010 catastrophic losses. HO-4 and HO-6 policyholders combined experienced less than 1% of the losses. Given the miniscule amount of losses in policy forms HO-4 and HO-6, removal of all catastrophic losses from

[134] Tr. 137:6-12.

policy form HO-3 projected losses is reasonable. In fact, assignment of the entire amount to HO-3 does not affect the overall indicated rate.[135] Accordingly, Mercury shall remove the entire $7,529,928 in December 2010 catastrophic losses from policy form HO-3.[136]

3. Calculation of Non-Modeled Catastrophe Adjustment

Catastrophic losses distort an insurer's data over the short-term and dramatically increase the indicated rate. As such, the Regulations remove non-modeled and modeled catastrophe losses from ratemaking to smooth out distortions caused by these infrequent events. Instead, an average catastrophe adjustment replaces the actual catastrophe losses in the rate formula.

a. Regulatory Formula & Applicable Law

The Regulations state an insurer's non-modeled catastrophic losses of any one accident year must be replaced by a "loading" based on a multi-year, long-term average of catastrophe claims.[137] For the homeowner's line, the average must be based on at least 20 years of data. Insurers with less than 20 years of data must supplement their figures as appropriate.

The catastrophe load modifies the amount of projected losses in the rate formula, and thus has a significant impact on the indicated rate. The first portion of the catastrophe load is calculated by taking a straight average of the ratios of total losses to non-catastrophic losses for the past 20 years. The second portion of the catastrophe load is derived from modeled fire following earthquake losses.

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[135] Tr. 1274:1-11; Tr. 1376:20-25.
[136] This results in a revised HO-3 historical loss total of $83,973,043 ($91,502,971 - $7,529,928).
[137] Cal. Code Regs., tit. 10, § 2644.5.

b. Findings re: Non-Modeled Catastrophe Losses

The ALJ finds by a preponderance of evidence the following facts regarding Mercury's historical rain losses. The ALJ also incorporates herein, Mercury's December 2010 winter storm losses.[138]

Mercury provided 17 years of catastrophe data along with its rate application. The catastrophe data notes fire, wind and mold losses dating back to 1994. Mercury did not supplement its data with three additional years as required by the Regulation.

During the first quarter of 2005, Mercury suffered more than $5.7 million in roof leak losses.[139] These losses coincided with a PCS classified catastrophic rainstorm from January 13 through January 15, 2005.[140] Mercury's roof leak losses significantly impacted its loss ratio. For example, Mercury's quarterly loss ratio jumped to more than 70%.[141] Because Mercury has historically ignored rain related losses when calculating its catastrophic losses, the 2005 rain losses were not factored into Mercury's catastrophe load.

c. Mercury's Proposed Approach

Mercury argues its December 2010 winter storm losses should be spread over 3.5 years, rather than the 20 years provided for in the Regulations.[142] Mercury contends this approach is consistent with the rate at which Mercury suffers catastrophic rain losses; i.e. every 3.5 years. In support of this argument, Mercury points to its January 2005 storm losses.

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[138] The facts provided pertain only to form HO-3, since the ALJ removed catastrophe losses from that form alone. The catastrophe factors for forms HO-4 and HO-6 are not in dispute and remain as calculated in Mercury's application.
[139] Exh. 51.
[140] Exh. 91.
[141] Exh. 437.
[142] Mercury's Post-Hearing Opening Brief, 34:3-11.

Alternatively, Mercury suggests the Commissioner calculate its catastrophe factor based on competitor catastrophe loads. Mercury asserts that if it excludes rain losses, like its competitors, its catastrophe adjustment will move closer to the industry average.[143] Adjusting Mercury's catastrophe load closer to the industry average would increase Mercury's load from 1.050 to 1.250; the industry mean as calculated by Ms. Bass.[144] A higher catastrophe load of 1.250 results in an increase in projected losses and a greater indicated rate.

d. CDI's Proposed Approach

The CDI recommends smoothing out the December 2010 rain losses over a five year period, and not the 20 years provided for in the Regulations.[145] The CDI's approach divides the December 2010 losses by five, and applies 20% of the losses in this year and the remaining 80% to the four following years.[146] This process results in a catastrophe load of 1.65%. The CDI's approach increases Mercury's catastrophe load and indicated rate.[147]

The CDI also rejects any use of the industry average to determine Mercury's catastrophe load, because no relationship exists between the catastrophe loads of unrelated insurers.[148] Further, the CDI notes Mercury's catastrophic losses are significantly lower than its competitors', and thus Mercury's catastrophe load should also be lower. As explained above, use of an industry average catastrophe load results in a higher indicated rate.

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[143] *Id.* at 33:17-24.
[144] *Id.* at 34:12-24; Exh. 96.
[145] CDI's Post-Hearing Opening Brief, 17:23-25.
[146] Tr. 283:8-13.
[147] CDI's Post-Hearing Opening Brief, 18:10-14.
[148] CDI's Post-Hearing Reply Brief, 13:11-20.

e. Consumer Watchdog's Proposed Approach

Consumer Watchdog promotes a straightforward application, which averages Mercury's catastrophic losses over its 17 years of experience. Consumer Watchdog removes Mercury's December 2010 catastrophic rain losses from the projected losses and includes those losses in the catastrophe load factor.[149] Having removed the $7.5 million, Consumer Watchdog calculates a dollar weighted catastrophe factor of 1.088 for the HO-3 form, which lowers the amount of projected losses.[150]

Consumer Watchdog also concedes it may be necessary for the Commissioner to modify Mercury's catastrophe factor based on its historical rain losses.[151]

f. Analysis and Conclusions re: Non-Modeled Catastrophe Factor

Having considered the facts and legal arguments presented, the ALJ concludes the most actuarially sound approach requires the Commissioner to consider historic rain losses in the catastrophe adjustment calculation.

As noted above, Mercury provided only 17 years of loss data, as the company did not write homeowner's insurance prior to that date. While the Regulation requires Mercury to provide supplemental data, none of the parties could identify other viable sources of supplemental data. Instead, the parties agreed that 17 years of data was close enough to the required 20 years. Given the lack of feasible supplemental data and Mercury's proximity to 20 years, in this instance the ALJ will calculate Mercury's catastrophe adjustment based on the 17 years of data.

[149] Consumer Watchdog's Post-Hearing Opening Brief, 14:25-15:2.
[150] Exh. 535.
[151] Tr. 1978:6-23.

i. Inclusion of Historic Losses Actuarially Sound

With the inclusion of $7.5 million in losses from the December 2010 storm, Mercury's catastrophe load equals 1.090. But such an approach fails to consider past catastrophic rain losses and is therefore incomplete. All parties agree that the most actuarially sound load must provide for catastrophic rain losses from Mercury's 17 year history.[152]

The only evidence of historically severe rain losses pertains to January 2005 claims experience. During that PCS-designated catastrophe Mercury suffered losses of approximately $7 million.[153] In addition, Mercury's quarterly loss ratio jumped to 70% while its annual loss ratio increased by 14.6%. Based on this evidence, the ALJ concludes the January 2005 storm was a catastrophe. As such, the ALJ finds Mercury's catastrophe adjustment must include $7 million in losses for 2005. As detailed in Appendix 1, Mercury's proper dollar weighted catastrophe factor is 1.100, with an average catastrophe factor of 1.062.[154]

ii. Regulations Do Not Permit Restrained Approach

Because Mercury historically excluded rain loss from its catastrophe factor, both Mercury and the CDI urge the Commissioner to implement the catastrophe load slowly. While the ALJ is sympathetic to Mercury's and the CDI's concerns, the ALJ concludes their methods are not the proper remedy for this concern.

The Regulation requires Mercury to include its December 2010 storm losses of $7.5 million in the catastrophe adjustment. But including only December 2010 rain losses skews the resulting catastrophe load. As a cure for this problem, Mercury and the CDI

[152] Tr. 1978:6-11; Tr. 1995:23-1996:6.
[153] $5,776,293 + approximately $1.2 million in other water and wind damage = $7 million.
[154] See Appendix 1 to this Proposed Decision.

support smoothing out the December 2010 rain losses over a several year period. However, this technique is inconsistent with the Regulations. Section 2644.5 requires removal of the entire catastrophic loss of any one year. The Regulation does not permit an insurer to exclude some catastrophic losses from the yearly total simply because it failed to comply with the Regulations in the past. The ALJ finds that altering the Regulations in such a way introduces bias into the ratemaking formula.

iii. Competitor Loads are Irrelevant

Mercury also advocates the Commissioner calculate its catastrophe load based on industry average. This contention ignores regulatory intent and fails to consider that insurance experience varies among carriers.

Mercury provided 17 years of loss experience data. Mercury's loss experience is not so incomplete that the use of supplemental data is warranted or necessary. Further the ALJ cannot find any regulatory or actuarial support for the use of an industry-wide average catastrophe adjustment. Had the Commissioner intended to apply an industry average to all insurers, the regulations would include such a provision.

In addition, Mercury's argument does not consider the impact of Mercury's past practice. Because Mercury has not previously considered rain losses as catastrophes, its catastrophe load is significantly smaller than its competitors'. In fact, while industry average equals 1.250, Mercury's catastrophe load equals 1.049.[155] Given Mercury's lower catastrophic loss history, use of an industry-average is imprudent.

4. Modeled Fire Following Earthquake Exposure

Determining Mercury's non-modeled catastrophe load (1.062) is a preliminary step in calculating the final catastrophe adjustment. In order to calculate the final

[155] Exh. 48-29.

catastrophe adjustment, the ALJ also must calculate the modeled catastrophe factor. The modeled catastrophe load is then added to the non-modeled catastrophe load of 1.062 to determine an aggregate catastrophe load. As stated above, the overall catastrophe load impacts an insurer's projected losses and overall indicated rate.

Insurers use catastrophe models to account for events that are extremely sporadic and generate high severity claims, such as hurricanes and earthquakes. These models, designed by insurance professionals, meteorologists, and engineers, estimate the likelihood of severe events and damages likely to result from those events.[156] The model then approximates the expected annual fire following earthquake (FFE) loss based on the insurer's exposure.

a. Regulatory Formula & Applicable Law

The regulatory formula permits insurers to employ catastrophe models to develop losses and cost containment expenses for FFE exposure.[157] The use of such models must conform to Actuarial Standards Board's standards of practice (ASOP 38) and the insurer must prove the model relies on the "best available scientific information" for assessing earthquake damage and loss.

ASOP 38 requires an actuary to employ the following steps prior to using a catastrophe model: (1) determine appropriate reliance on experts; (2) have a basic understanding of the model; (3) evaluate whether the model is appropriate for the intended application; (4) determine that appropriate validation occurred; and (5)

[156] Werner & Modlin, Basic Ratemaking, p. 98.
[157] Cal. Code Regs., tit. 10, § 2644.4, subd. (e).

demonstrate appropriate use of the model.[158] An actuary may rely on another actuary who has evaluated the model.[159]

ASOP 38 also instructs an actuary to consider results from other models and compare historical observations to modeled results. Further, ASOP 38 urges an actuary to address the reasonableness of model output and ensure accurate model input.

The Regulation does not define "best available scientific information."

b. Findings re: Mercury's Use of Fire Following Earthquake Model

A preponderance of the evidence establishes the following facts regarding the fire following earthquake model and Mercury's application of that model.

i. RMS & RiskLink 9.0

Risk Management Solutions (RMS) is one of three major fire following earthquake modelers. All three major modelers, RMS, EQECAT, and Air Classic, rely on the same starting point; the 2008 National Seismic Hazard Mapping Project conducted by the U.S. Geological Survey.[160] Because each model relies on the same Hazard Map, the frequency and intensity portions of all earthquake models are similar. And yet, each model produces a different result based on the model's treatment of vulnerability, insurance claims, fire spread, and an insurer's exposure.[161]

RiskLink is the name given to RMS's fire following earthquake model. The model begins with a process designed to simulate and develop a distribution of fire loss indices (FLIs) for major cities. FLIs represent the probability that a location will sustain a complete fire loss for a given level of ground shaking. RMS simulates the ground shake

[158] Exh. 9-7.
[159] Exh. 9-9.
[160] Tr. 615:8-21; Tr. 1866:21-23.
[161] Tr. 552:7-18.

more than 25,000 times to cover a range of uncertainties, including fire ignition, fire spread and fire suppression.[162] Fire ignition is a function of the size and time of day of an earthquake, building square footage and the mix of lines of businesses. Fire spread addresses the construction materials, the distance between buildings and the climate conditions. And fire suppression is primarily the number of fire engines available in the area.[163] RMS records the mean burnt area for each simulation and performs a regression to express the mean burnt area as a function of the level of shaking. This regression generates the FLIs RiskLink applies to an insurer's exposure.

RMS simulated results in five California cities. These simulations incorporated weather conditions specific to each city, as well as temperature and wind speed distributions.[164] Ninety percent of actual fire following earthquake losses occur in these five cities.[165]

When a client enters their exposure data into the model, RiskLink geocodes their information. Geocoding converts addresses into a spatial reference system recognized by the model. Essentially, RiskLink translates local addresses (i.e. street name and number) into global coordinates and assigns a variety of characteristics such as soil type and liquefaction to each coordinate based on the simulated FLIs.[166]

Since the release of version 9.0 in April 2009, RMS issued RiskLink versions 10.0 and 11.0.[167] RMS updated RiskLink to address changes in terrorism models and to adjust for weather-related disasters outside the United States. RMS did not alter the U.S. earthquake model or the accompanying FLIs, nor did RMS rerun the simulations

[162] Windeler PDT, 4:24-25.
[163] *Id.* at 4:16-23.
[164] Tr. 1843:5-10.
[165] Tr. 1843:23-1844:4.
[166] Windeler PDT, 7:11-13.
[167] *Id.* at 6:15-18.

discussed above.[168] The primary difference between the versions is the updated geocoding data included in each.[169]

ii. RMS Response to ASOP 38

In October 2010, RMS distributed a document intended to assist actuaries working with RiskLink 9.0 (ASOP Response).[170] This non-proprietary document addresses each of the categories an actuary must explore prior to adopting a model. It is the only model-specific document Ms. Gao reviewed prior to employing RiskLink 9.0.

The ASOP Response lists the staff RMS employed to create and review RiskLink. The staff includes actuaries, geologists, engineers, economists, computer scientists and mathematicians. In addition, RMS retained two independent experts to review the model. Neither expert, however, reviewed the RiskLink version used by Mercury.[171]

The ASOP Response also addresses methods used to validate RiskLink 9.0. But the Response is not intended as a substitute for an actuary's own validation.[172] While the document provides a validation summary, an actuary may request additional validation documents. Mercury did not request additional validations documents.[173]

Mercury supplemented the ASOP Response with modeled loss estimates for historical California earthquake events. While the actual modeled results remain under seal, the ALJ notes RiskLink's modeled losses were significantly larger than the actual incurred FFE losses for each earthquake event.[174]

[168] Tr. 1865:6-12.
[169] Tr. 1868:1-7.
[170] Exh. 16.
[171] Exh. 16-24.
[172] Exh. 16-75.
[173] Tr. 377:20-24.
[174] Exh. 100-8.

iii. Mercury's Use of RiskLink 9.0

Absent a compelling reason, insurers do not routinely switch fire following earthquake models.[175] Prior to this rate application, Mercury routinely employed the Air Classic FFE model.[176] Mercury did not explain its decision to replace the Air Classic model.[177]

In 2011, Mercury hired Aon Benfield to model its fire following earthquake exposure through RiskLink 9.0. Mercury provided Aon with data on each of its insurance lines through December 31, 2010. Aon ran the FFE model by combining all of Mercury's lines, excluding the auto line. Aon did not review the validity of Mercury's data nor did Aon model losses specifically for Mercury's homeowner's book of business. RiskLink 9.0 projected FFE losses totaling $4.6 million.

On its own initiative, Aon also ran Mercury's data through two other competing catastrophe models; EQECAT and Air Classic. The EQECAT model estimated FFE losses of $3.5 million, while the Air Classic model projected FFE losses of $5.9 million.[178]

c. Mercury's Contentions

Mercury contends RiskLink 9.0 conforms to ASOP 38. In support of this contention, Mercury relies on the testimony of Ms. Gao and RMS's ASOP Response. First, Mercury notes the creators of RiskLink 9.0 originated from disciplines one would expect to see in the development of catastrophe models and include two independent

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[175] Tr. 363:2-4.
[176] Exh. 522-14.
[177] Tr. 501:1-3.
[178] Fox PDT, 6:9-13.

experts.[179] Second, Mercury argues Ms. Gao understood the model and evaluated whether the model was appropriate for Mercury's use. Third, Mercury asserts the model has been validated. because the RiskLink 9.0 results fall between the results from other models, and are consistent with historical losses.[180]

Mercury also contends RiskLink 9.0 is based on the best scientific information available. In support of this argument, Mercury relies on the testimony of Mr. Windeler and the competitive modeling market. Mercury argues that by using one of the three established FFE models, all of which rely on the same U.S. Hazard map, the insurer demonstrates it relied on the best scientific information.[181] In addition, Mercury notes Mr. Windeler extensively explained how RMS generates its FLIs and fire simulation models and provided documents that demonstrate RMS complied with the Regulation.[182]

d. Consumer Watchdog's Contentions

Consumer Watchdog contends Mercury did not adequately support and document its use of RiskLink. First, Consumer Watchog notes Ms. Gao only reviewed RMS's "marketing brochure" regarding RiskLink 9.0. The Intervenor asserts this document fails to demonstrate the model complies with ASOP 38. Second, Consumer Watchdog notes Ms. Gao did not request additional information nor did she fully vet RMS's experts.[183] Lastly, Consumer Watchdog states Ms. Gao inaccurately testified as to the model's prior use, thereby indicating Ms. Gao merely "rubber-stamped" the use of RiskLink 9.0.[184]

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[179] Mercury's Post-Hearing Opening Brief, 36:19-25.
[180] *Id.* at 38:1-13.
[181] *Id.* at 40:6-11.
[182] *Id.* at 40:14-18.
[183] Consumer Watchdog's Post-Hearing Opening Brief, 25:1-21. The CDI does not join Consumer Watchdog in this argument.
[184] *Id.* at 25:22-26.

e. Analysis and Conclusions re: Use of RiskLink 9.0

Having considered the facts and legal arguments, the ALJ concludes RiskLink 9.0 conforms to actuarial standards of practice and is based on the best scientific information available.

i. Mercury Complied with ASOP 38

Regulation 2644.4 does not require Ms. Gao to become an expert in the model used. Mercury demonstrated Ms. Gao possessed a basic understanding of the model, considered the proper experts, and evaluated the model for its intended use.

Evidence also establishes sufficient model validation. RMS compared its model to historical earthquake losses and with competitor models, and found the output to be consistent with its own. The ALJ credits Mr. Windeler's testimony that the modeled losses reflect losses at today's value, and if one inflated the actual losses to today's dollar value, the modeled losses would be much closer to the actual loss value.[185] The ALJ is also satisfied with the testimony of Mr. Fox, who stated the variability between the three modeled results is in line with the uncertainties surrounding fire following earthquake modeling.[186]

While Mercury failed to explain its decision to change FFE models, such a failure does not lead the ALJ to conclude Ms. Gao "rubber-stamped" the model's use. Having found no reason to discredit RMS's model, the ALJ concludes RiskLink 9.0 complies with ASOP 38.

[185] Tr. 1860-1861:19-3.
[186] Tr. 1869:4-6.

ii. RiskLink is Based on Best Available Information

RiskLink 9.0 relies upon the most recent U.S. Geological Seismic Hazard Map. The Hazard Map is the best scientific information available with regard to earthquake losses. Having no evidence to the contrary, the ALJ concludes RMS's model relies upon the best available scientific information.

5. Mercury's Fire Following Earthquake Losses and Load

Modeling Mercury's FFE losses is merely the first step in determining the FFE portion of the catastrophe load. In order to determine the FFE load factor, an insurer must calculate the ratio of average annual FFE losses to ultimate non-catastrophic losses. The parties do not agree on how to compute the FFE ratio, nor do they agree on how to adjust the FFE ratio beyond December 31, 2010, when Mercury ran the RMS model.

a. Regulatory Formula & Applicable Law

The Commissioner's regulations do not contain any applicable law on this issue. When the regulatory formula fails to provide a specific methodology, "the ALJ must adopt an approach based on generally accepted actuarial principles, expert judgment and standards of reasonableness."[187]

b. Findings re: Mercury's FFE Ratio

RiskLink 9.0 modeled $4.6 million in FFE losses based on the data period ending December 31, 2010. Rather than using the $4.6 million in FFE losses, Mercury chose to calculate its ratio based on $4.1 million in FFE losses. Mercury did not explain why it selected this amount. In arriving at 2010 ultimate losses of $4.1 million, Mercury applied a positive trend of 1.028 or 2.8% to its FFE losses.

[187] *In the Matter of the Rate Application of Allstate Insurance Company*, PA-2006-00006, p. 12.

After selecting $4.1 million in FFE losses, Mercury divided the FFE losses by $98.8 million; the amount Mercury calculated as its 2010 ultimate non-catastrophe losses.[188] This resulted in a FFE ratio of 4.2% or 0.042.[189] Mercury then applied this ratio to its ultimate losses as of September 30, 2011, to account for the change in exposure.

Mercury added its FFE factor of 0.042 to its average catastrophe factor of 1.49 to determine its overall catastrophe factor of 1.091.[190]

c. CDI's Contentions

The CDI makes three separate arguments regarding Mercury's FFE load. First, the CDI takes issue with Mercury's trending of its FFE losses. Second, the CDI argues Mercury inflated its FFE ratio by using improper calculations. Third, the CDI argues Mercury failed to update the RMS modeled results with more recent data.[191]

The CDI takes issue with Mercury's decision to apply a 1.028 positive trend to the FFE losses. Trending is used to move historical losses to their current value. The Department does not believe it is necessary to trend these losses because it believes these losses are already at their maximum. The CDI also argues that if trending is necessary, the applicable trend must be negative, not positive, because Mercury's average claim costs are decreasing by approximately 3.9%.[192] The CDI further notes Mercury failed to explain or support its trend selection. By trending the FFE losses, Mercury increases the FFE ratio and thereby increases the overall catastrophe adjustment

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[188] Exh. 110-1.
[189] $4.1/98.8 = .042
[190] Exh. 48-29.
[191] Consumer Watchdog does not join the CDI in this argument.
[192] CDI's Post-Hearing Opening Brief, 26:20-25.

The CDI also argues Mercury inflated its FFE ratio of 4.2% by using a denominator from the wrong time period.[193] CDI's argument is best explained by demonstrating the resulting ratios. As noted above, Mercury divided its FFE losses of $4.1 million by $98.8 million (its ultimate losses from the period ending December 31, 2010) to get the resulting 4.2% ratio. But if one divides FFE losses of $4.1 million by $111.6 million (the ultimate losses from the period ending September 30, 2011) the FFE ratio is 3.68%. The CDI argues the proper denominator in this equation is $111.6 million and a 3.68% ratio must be applied to Mercury's rate application.[194]

As a continuation of the above argument, the CDI also objects to how Mercury justified the use of a 4.2% ratio for September 2011 data. The Department notes that when Mercury applied the 4.2% ratio to September 2011 data, Mercury assumed the FFE losses would increase by a corresponding amount. That is, Mercury's method assumes that if the FFE losses were 4.2% of 2010 non-catastrophe losses, they will also be 4.2% of September 2011 non-catastrophe losses, regardless of whether losses increased or decreased.[195] The CDI suggests a better approach would be to rerun the RiskLink model as of September 30, 2011.

d. Mercury's Contentions

Mercury argues its FFE losses are not yet trended to future cost level. In selecting a nearly 3% trend, Mercury relies upon its own trend calculations as well as "some data from Marshall Swift Boeckh."[196] Mercury did not, however, provide this data to the parties or the ALJ, nor did Mercury explain this omission.

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[193] *Id.* at 27:7-24.
[194] CDI's Post-Hearing Reply Brief, 16:13-18.
[195] CDI's Post-Hearing Opening Brief, 28:3-9.
[196] Mercury's Post-Hearing Opening Brief, 46:19-23.

Mercury also states its application of the 4.2% ratio to September 30, 2011, ultimate losses is actuarially sound. Mercury concedes that FFE losses are not proportional to changes in earned premium or losses. But Mercury states adjusting losses in this manner is a common actuarial technique and the most appropriate method to adjust the FFE losses.[197] Mercury further argues the precision from rerunning the FFE model would be minimal.

e. Analysis and Conclusions re: FFE Catastrophe Load

Having considered both the facts and legal arguments raised by the parties, the ALJ concludes Mercury failed to support its trending of the FFE losses. But, the ALJ finds that given the information provided, Mercury's 4.2% FFE ratio is actuarially sound.

i. Mercury's Method of Adjusting to September 2011 is Actuarially Sound

The CDI finds faults with Mercury's decision to apply its 2010 FFE loss ratio to September 30, 2011 non-catastrophic losses. The ALJ understands CDI concerns about Mercury's failure to update the model. But based on evidence presented, the ALJ concludes Mercury's adjustment is actuarially appropriate.

The CDI suggests the Commissioner directly divide Mercury's FFE losses by the non-catastrophic losses for the period ending September 30, 2011 in order to determine the proper FFE ratio. However, this suggestion fails to take into account the differing data periods. Mercury calculated its FFE losses as of December 30, 2010. A proper ratio requires a denominator from the same time period. The CDI's method uses a numerator based on December 31, 2010 data and a denominator based on September 30, 2011 data. Changing time periods results in an inaccurate assessment. While it may be tempting to

[197] *Id.* at 46:1-7.

simply divide the FFE losses by the updated time period, it is not the most actuarially sound approach.

Instead of using different time period to calculate the ratio, the ALJ finds it is more actuarially sound to assume the FFE ratio remained the same during the next nine months. While the updated time period may alter the ratio somewhat, the change is likely minimal and its impact on the overall indicated rate is negligible.[198] Accordingly, the ALJ concludes application of a 4.2% FFE loss ratio is supported by the evidence presented.

ii. Trending of FFE Losses is Inappropriate

Mercury chose to trend its 2010 FFE losses by 1.028 or 2.8%; an amount Mercury asserts is supported by MSB data. Yet Mercury does not provide any of the relied upon MSB data nor does Mercury demonstrate it is necessary to trend FFE losses.
Even if trending is necessary, it appears Mercury's decision to trend based on losses rather than premium is equally unsupported. The ALJ concludes Mercury fails to meets its burden regarding the trending of modeled FFE losses, but the ALJ also finds this issue has no significant impact on Mercury's FFE ratio.

iii. Selected HO-3 Catastrophe Factor

Having determined the average catastrophe factor of 1.062 and Mercury's modeled fire following earthquake load of .042, the ALJ concludes Mercury's HO-3 catastrophe factor equals 1.100.[199] The ALJ's calculations can be found in Appendix 2 of this decision.

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[198] CDI's Post-Hearing Opening Brief, 2:7-8.
[199] See Appendix 2 of this Proposed Decision.

6. Loss Development

The cost for the insurance product is not fully known when the contract is provided or even when a claim is first reported. As a claim matures, claim adjusters gather more information about the value of the loss until the final payment is made and the ultimate amount is known. As the ratemaking formula uses the most recent accident year data available, the historical losses are to some degree immature and therefore the ultimate loss amount is not yet known. The process of adjusting immature losses to an estimated ultimate value is known as loss development.[200] A loss development factor greater than 1.0 decreases the loss amount but has a minimal impact on the overall indicated rate.[201]

a. Regulatory Formula & Applicable Law

The Commissioner's regulations state that loss development shall exclude catastrophes and shall be presented as a loss-development triangle, based on the dollar-weighted average of the ratios of losses for the three most recent accident years, policy years or report years available.[202] These age-to-ultimate development factors are then applied to the reported losses at the most recent period of development (the latest diagonal in the reported loss triangle) to yield the estimated ultimate losses for each accident year.[203]

b. Findings re: Mercury's Loss Development Factors

A preponderance of evidence establishes the following facts regarding Mercury's loss development data.

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[200] Werner & Modlin, Basic Ratemaking, p. 105.
[201] Tr. 1889:11-14; The rate impact between CDI's and Mercury's loss development factors equals 0.19%.
[202] Cal. Code Regs., tit. 10, § 2644.6.
[203] Foundations of Casualty Actuarial Science (Casualty Actuarial Society 2001) p. 101.

Mercury selected loss development factors of 1.002 for property losses and 1.007 for liability losses. Selection of these factors led to a total loss development factor of 1.111 for policy form HO-3, 1.174 for policy form HO-4 and 1.086 for policy form HO-6.[204] In arriving at these loss development factors, Mercury applied the dollar-weighted average to the first 72 months of development. After applying the dollar-weighted average to the first 72 months, Mercury still possessed five additional quarters of data. Instead of adding those five additional quarters to its loss development triangle, Mercury used a double exponential curve to produce the tail factors for the remaining five quarters of data.[205] Mercury did not provide any development data for the five additional quarters beyond the 72 months displayed in the loss development triangles.[206]

i. HO-3 Loss Development

Examination of the Mercury's loss development triangle for HO-3 liability losses shows a decrease in losses after 63 months.

Accident Qtr	*60*	*63*	*66*	*69*	*72 +*
2004-4	1,380	1,384	1,384	1,380	1,383

In accident quarter 2004-4, Mercury's 63 month loss development equaled 1,384. At 69 months, loss development drops to 1,380, but then increases to 1,383 at 72+ months without explanation.[207] A similar inspection of Mercury's loss development triangle for HO-3 property losses shows decreasing or steady loss amounts after 57 months. In accident quarter 2004-4, Mercury's 57 month loss development equals 13,344, and decreases to 13,246 at 72+ months.[208]

[204] Exh. 48-35; Exh. 49-35; Exh. 50-35.
[205] Tr. 506:23-507:7.
[206] Tr. 507:3-7.
[207] Exh. 48-48.
[208] Exh. 48-50.

ii. HO-4 Loss Development

Similar results can be found when reviewing loss development for policy form HO-4. As seen in the table below, Mercury's property loss development remained steady while Mercury chose a positive 1.002 loss development factor.[209]

Accident Qtr	*60*	*63*	*66*	*69*	*72 +*
2004-4	191	191	191	191	191

In fact, for accident quarter 2004-4, Mercury's property loss development remained the same for the last 3 years. Likewise, Mercury's liability loss development has not changed in the last several years, despite Mercury's selection of a 1.007 loss development factor.[210]

iii. HO-6 Loss Development

An analogous result is found when reviewing Mercury's HO-6 loss development triangles. For liability, Mercury's accident 2004 fourth quarter loss development has remained at 87 for the past 3 years.[211] Mercury's property loss development remained steady for 4 years, and then inexplicably rose, as seen in the table below.[212]

Accident Qtr	*60*	*63*	*66*	*69*	*72 +*
2004-4	456	456	456	456	461

c. Mercury's Contentions

Mercury contends standard actuarial practice requires the use of a tail factor when development data beyond 72 months is available. A tail factor accounts for development beyond that included in the standard loss development triangle. Mercury claims actuaries should not "cut off" development simply because the Regulations call for such an end.

[209] Exh. 49-50.
[210] Exh. 49-48.
[211] Exh. 50-48.
[212] Exh. 50-50.

Instead, Mercury argues actuaries should fit curves to all the existing data.[213] And because Mercury possessed five additional quarters of data, Mercury concludes its use of a tail factor is appropriate.

Mercury also argues the Regulation permits an insurer to develop its losses beyond the 72 months specified. Mercury relies on the Regulation's silence to support its contention.[214]

d. CDI's Contentions

The CDI contends Mercury did not calculate its loss development factors using the dollar-weighted average ratio of losses, as evidenced by the use of a tail factor.[215] The CDI notes that although Mercury's loss development triangles reveal Mercury possessed at least five additional quarters of data, Mercury did not provide such data or demonstrate why such data should be included.[216] Absent such a showing, Mercury's use of a tail factor is inappropriate.

In addition, the CDI contends Mercury's loss development factor should be negative.[217] The CDI notes that Mercury's property and liability loss development is negative after 63 months of data and any subsequent increases are unexplained. For example, although Mercury selected a liability development factor of 1.002, Mercury's property losses after 69 months are actually dropping from 13,344 to 13,246. As such, the appropriate loss development factor should be less than 1.00.[218]

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[213] Mercury's Post-Hearing Opening Brief, 61:3-14.
[214] *Id.* at 61:15-23.
[215] Consumer Watchdog does not challenge Mercury's loss development factors.
[216] CDI's Post-Hearing Opening Brief, 28-29:22-21.
[217] CDI's Post-Hearing Reply Brief, 19:17-21.
[218] *Id.* at 19:18-19.

e. Analysis and Conclusions re: Loss Development Factors

Having considered both the undisputed facts and legal arguments raised by the parties, the ALJ concludes that while the Regulations permit the use of a tail factor, Mercury fails to support its use in this matter.

i. Regulation Permits Use of Tail Factor

In many casualty lines, the loss development triangle may end before the insurer settles all claims and calculates all costs. A tail factor accounts for loss development beyond the end of the displayed triangle.[219] When an insurer selects a tail factor, it considers industry data and any relevant data available. The method used, however, is subjective.

While the Regulation is silent on this matter, evidence shows tail factors are a necessary and normal part of developing losses to ultimate value. Indeed, neither party disputes the importance of tail factors. Accordingly, the ALJ concludes use of a tail factor is not specifically prohibited by the Regulation.

ii. Mercury Failed to Support its Tail Factor

That said, Mercury failed to support use of its loss development tail factor. Mercury did not present any loss development data beyond the 72 months shown in its triangles and did not explain this failure. While Ms. Gao's admitted that she applied a double exponential curve, that does not satisfy Mercury's obligation regarding the use of a tail factor. Mercury could easily have provided the data showing the need for a tail factor and simply chose not to. As Mercury bears the burden of proof with regard to each of its selected factors, its failure to provide the Commissioner with the underlying data is

[219] Werner & Modlin, Basic Ratemaking, p. 108.

fatal. This failure is especially telling given that the insurance industry generally considers homeowners insurance to be a short-tailed line, where claims settle quickly.

In addition, Mercury does not explain why it selected positive tail factors given its decreasing property and liability losses. For instance, while Mercury chose a positive loss development factor of 1.002, evidence shows its property losses decreased or steadied after 57 months.[220] A similar result can be found in reviewing the liability and property losses in policy forms HO-4 and HO-6.

Given Mercury's failure to provide the additional five months of data and the decreasing loss amounts, the ALJ concludes Mercury failed to support its selected loss development factors. Although the CDI suggests the Commissioner apply negative loss development factors to Mercury's rate application, the ALJ finds that losses appear to be steady after 72 months. Accordingly, having recalculated Mercury's loss development absent the tail factors, the ALJ concludes the proper loss development factor shall equal 1.109 for HO-3, 1.170 for HO-4 and 1.084 for HO-6.[221]

7. Loss Trend Selection

It is also necessary to adjust the losses for underlying economic trends expected to occur between the historical experience period and the period for which the rates will be in effect. Claim frequencies and claim costs are both impacted by underlying economic indicators that may change expected levels over time. For example, monetary inflation, increasing medical costs, advancements in safety technology and other social influences

[220] Exh. 48-50.
[221] Because Mercury assumes the DCCE development factors equal the loss development factors, the DCCE development factors shall also be calculated at 1.109, 1.170 and 1.084.

may influence both claims and costs.[222] Actuaries refer to these changes in frequency and severity as loss trends.

a. Regulatory Formula & Applicable Law

Loss trend is measured by excluding catastrophic losses and fitting curves to the remaining historical data; a mathematical computation demonstrated in Exhibits 530 through 534.[223] In addition to analyzing the pure premium data, frequency and severity figures are analyzed separately to better understand the underlying drivers of the trend. Insurers then select a historical data period based on the actuary's judgment. The single data period selected must be the most actuarially sound, considering both responsiveness and stability.[224] If separate frequency and severity trends are selected, these selected trends are combined to a single pure premium trend. For example, a negative 1% selected frequency trend and a positive 2% selected severity trend combine to produce a positive 1% (= (1.0 - 1%) x (1.0 + 2%) - 1.0) selected pure premium trend. Generally, selection of a positive trend results in a higher indicated rate.[225]

b. Findings re: Trend Selection

The ALJ finds by a preponderance of evidence the following facts regarding the selected trends and applicable economic indicators.

Mercury initially selected a 16-point annual pure premium trend for each of the policy forms at issue.[226] For the HO-3 form, Mercury's selection results in a positive trend of 1.4%.[227] For forms HO-4 and HO-6, Mercury's selection results in positive

[222] Foundations of Casualty Actuarial Science, p. 103.
[223] Cal. Code Regs., tit. 10, § 2644.7, subd. (b).
[224] Exh. 5-7.
[225] Tr. 1175:13-15.
[226] Tr. 323:17-24; Gao PDT, 14:6-9.
[227] Exh. 48-47.

trends of 5.2% and 9.3%.[228] Contrary to the Regulatory mandate, Mercury did not remove the December 2010 catastrophic losses prior to making its trend selections.

The ALJ finds that removing $7.6 million in catastrophic losses from each of the policy forms results in the following lost cost trend calculations.[229]

i. HO-3 Trend Summary

Number of Points	Loss Severity	Loss Frequency	Loss Cost	Premium	Net Loss to Premium
24	3.0%	1.7%	4.7%	1.6%	3.0%
20	0.4%	3.3%	3.6%	0.9%	2.7%
16	-1.1%	0.7%	-0.4%	0.4%	-0.8%
12	-3.4%	1.3%	-2.1%	0.7%	-2.8%
8	3.8%	-1.6%	1.9%	0.2%	1.7%

ii. HO-4 Trend Summary

Number of Points	Loss Severity	Loss Frequency	Loss Cost	Premium	Net Loss to Premium
24	6.6%	4.7%	11.6%	-1.3%	13.1%
20	6.8%	6.0%	13.2%	-1.3%	14.7%
16	5.9%	3.7%	9.9%	-1.1%	11.1%
12	5.9%	-4.1%	1.5%	-0.7%	2.3%
8	20.4%	-11.4%	6.7%	-0.2%	6.9%

iii. HO-6 Trend Summary

Number of Points	Loss Severity	Loss Frequency	Loss Cost	Premium	Net Loss to Premium
24	7.0%	5.1%	12.5%	1.2%	11.1%
20	6.2%	5.2%	11.7%	1.4%	10.2%
16	5.0%	4.9%	10.2%	1.6%	8.5%
12	-2.7%	2.4%	-0.4%	1.7%	-2.0%
8	-2.3%	3.3%	1.0%	2.0%	-1.0%

[228] Exh. 49-47; Exh. 50-47.

[229] Exh. 530. The parties agree this is an accurate reflection of loss trends absent $7.6 million in December 2010 catastrophic losses.

iv. Findings re: Economic Indicators

In a free-market economy, prices for construction material and labor vary, often significantly, among neighboring states and even cities. As future claim costs greatly impact insurance losses and trends, property insurers regularly consult recognized authorities in the reconstruction industry. Consumer Watchdog offered a California-based analysis from Xactware Solutions, while Mercury offered a nationwide analysis based on Dr. Appel's own index.

Xactware Solutions is a recognized authority in reconstruction industry and specializes in providing analysis to insurers. Xactware's Property Reports analyze how catastrophes and other losses influence the cost to rebuild in many states across the country. Similarly, Xactware's Industry Trend Reports demonstrate how prices have changed in key construction industry indicators such as lumber and labor. Because rebuilding costs fluctuate with the economy, the ALJ finds Xactware's reports relevant to determining the proper trend.

Xactware's 2010 Property Report concludes the reconstruction cost index in California decreased by 1.5%.[230] In 2011, Xactware noted the reconstruction cost index in California grew by only 0.5%, while the national average grew 1.52%.[231] In addition, Xactware's California Industry Trend Report shows virtually no increase in labor and materials costs from January 2009 to the present.[232] California trends appear to differ from the national averages. For example, while California's labor and materials costs remain stagnant, nationwide labor and material costs are arguably on the rise.[233]

[230] Exh. 547.
[231] Exh. 546.
[232] Exh. 548.
[233] Exh. 97.

California's Employment Development Department provides additional data which demonstrates a stagnant California construction industry. Much of California's unemployment rate of 11.4% is tied to the collapse of the housing market. Jobs in the California construction industry fell more than 40% from 2006 to 2011, and mirrored construction permit activity which also declined more than 40%.[234]

Dr. Appel also created a "Repair Cost Index" based on nationwide U.S. Labor Department data. Dr. Appel's index relies on the national Producer Price Index and average weekly earnings for construction industry employees.[235] In order to evaluate the nationwide change in insurance repair costs, Dr. Appel assigned weights to each factor.[236] The resulting index finds the cost of construction materials and supplies has increased nationwide in the last several years, as have labor costs. The index also concludes inflation will rise approximately 4% over the next several years.[237]

On remand, the Commissioner requested the parties present additional evidence regarding the most actuarially sound data period and complement of credibility for policy forms HO-4 and HO-6. The parties responded to the Commissioner's request by stipulating that all relevant evidence had been presented during the evidentiary hearing and no additional evidence is available.[238]

c. Mercury's Contentions

Mercury selects one trend if catastrophic losses are included and another if catastrophic losses are excluded.

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[234] Exh. 550.
[235] The Producer Price Index measures the average change over time in the selling prices received by domestic producers for their output.
[236] Appel PRT, 5:23-6:4.
[237] *Id.* at 7:14-22.
[238] ALJ Exh. 1.

If the projected losses include December 2010 catastrophic losses, Mercury argues for 16 point trend selections for all coverage forms.[239] Mercury argues the most reliable data comes from the last 16 quarters; that is from September 2007 through June 2011. Mercury's trend selection indicates its belief that claim cost and frequency nationwide will continue to rise. In so concluding, Mercury argues one should not rely on calculated loss ratios. Though loss ratio may decrease over time, Mercury contends a corresponding decrease in losses is not guaranteed.[240] Accordingly, Mercury selected trends of 1.4% for HO-3, 5.2% for HO-4 and 9.3% for HO-6.

If projected losses exclude December 2010 catastrophe losses, Mercury argues for entirely different trends. Mercury refrains from selecting a specific trend period, but argues in favor of longer trend periods of 20 or 24 points for all coverage forms.[241] In support of this argument, Mercury points to the state of the U.S. economy and its own historical severity losses.

Mercury rejects Consumer Watchdog's California construction data in favor of nationwide data compiled by its own witness. Mercury argues Dr. Appel's chart demonstrates a national increase in the "Repair Cost Index." Mercury notes the cost of construction materials and supplies has increased in the last several years, as have labor costs. Mercury concludes this data demonstrates inflation will rise approximately 4% nationwide over the next several years.[242]

Mercury also notes its severity data fluctuates year to year. It argues these fluctuations support use of a longer trend, which would account for upward and

[239] Mercury's Post-Hearing Opening Brief, 64:16-18.
[240] *Id.* at 67:13-22.
[241] *Id.* at 75:9-13.
[242] *Id.* at 73:3-7.

downward anomalies.[243] For example, Mercury notes that if one selects a 16 point trend, data from 2005 through 2007 is omitted. This is problematic because severity losses increased from 2005 through 2007, but decreased from 2009 through 2010. Mercury argues that if the economic conditions of 2005-2007 cannot be expected to repeat, there is no reason to believe the economic conditions from 2009-2010 will repeat. That is to say, if the Commissioner omits data that increases the trend and retains data that decreases the trend, bias is introduced into the ratemaking calculation.[244] Instead, Mercury advocates for a 20 or 24 point trend, since those trends take into consideration the relevant long-term fluctuation in severity.

d. CDI's Contentions

The CDI argues Mercury's December 2010 catastrophic losses must be removed prior to trend selection. Having removed approximately $6.5 million in catastrophic losses, the CDI selected the 16 point period for policy form HO-3. This results in a positive trend of 1.4% as shown in Exhibit 336.[245]

For policy form HO-4, the CDI chose a 12 point period which results in a positive net trend of 1.14%.[246] The CDI points to Mercury's loss ratios over the last three years to support its argument. For instance, Mercury's loss ratio as of September 30, 2009 equaled 47.14%. Two years later, as of September 30, 2011, Mercury's loss ratio fell to 36.89%. The CDI believes the steady decrease precludes a large positive trend selection and demonstrates that a trend greater than 1.14% is not the most actuarially sound.[247]

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[243] *Id.* at 74:11-14.
[244] *Id.* at 74:11-25.
[245] CDI's Post-Hearing Opening Brief, 30:1-7.
[246] Gammell PADT, 8:5-11.
[247] CDI's Post-Hearing Opening Brief, 30:8-25.

For form HO-6, the CDI selected an 8 point data period with a positive net trend of 1.32 %.[248] The CDI's rationale for this selection mirrors that above, i.e. the last three years demonstrate a decrease in ultimate loss ratios undermining Mercury large trend selection. In addition, the CDI notes the largest changes in frequency and severity came in 2008. Including 2008 data in the trend selection would thus add large fluctuations without reason or support.[249]

e. Consumer Watchdog's Contentions

Consumer Watchdog preliminarily challenges the parties' interpretation of Section 2644.7. As noted above, insurers must file a rate change application using the most actuarially sound single data period. Consumer Watchdog contends this provision requires insurers to select the same trend period for each policy form under consideration.[250] If the Commissioner believes a single trend period is most actuarially sound, Consumer Watchdog advocates for a 16 point trend for all policy forms. CDI and Mercury state section 2644.7 permits insurers to select different trend periods for different policy forms.

Consumer Watchdog's trend calculations also differ from CDI's and Mercury's. First, the Intervenor removed $7.5 million of alleged catastrophic losses from historic losses prior to trend calculation. After removing catastrophic losses, Consumer Watchdog selected a 16 point trend for the HO-3 form, which results in a negative trend of 0.4%.[251] Consumer Watchdog rejected trends based on 20 and 24 points since they included

[248] *Id.* at 31:2-4.
[249] CDI's Post-Hearing Reply Brief, 15:4-6.
[250] Consumer Watchdog's Post-Hearing Opening Brief, 16:3-13.
[251] Exh. 530.

distortions the Intervenor did not believe would repeat in the future.[252] Both the 20 and 24 points data sets producted positive net trends.[253] Relying on Mr. Schwartz's testimony, Consumer Watchdog contends that current economic conditions differ from those experienced between 2005 and 2007, making use of a 20 point trend unreasonable.[254]

For form HO-4, Consumer Watchdog selected a 12 point trend which, after credibility rating, results in a positive trend of 1.1%. For form HO-6, Consumer Watchdog again chose a 12 point trend resulting in a negative .1% after credibility rating.[255] In selecting 12 point trends for these policy forms, Consumer Watchdog notes the longer trends demonstrate significantly higher net trends as a result of random statistical fluctuations that are not expected to repeat in the future.[256]

f. Analysis and Conclusions re: Applicable Loss Trends For Each Policy Form

Having considered the facts and legal arguments, the ALJ concludes the following trends apply. For policy form HO-3, the ALJ applies a 16 point loss trend of -0.4%. For policy form HO-4, the ALJ applies a 16 point loss trend of 5.2%. And for policy form HO-6, the ALJ selects a 16 point loss trend of 9.3%. While the loss trend for HO-3 is negative and the loss trends for HO-4 and HO-6 are positive, these trends represent the most actuarially sound trends based on all available evidence, as discussed more fully below.

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[252] Consumer Watchdog's Post-Hearing Opening Brief, 16:19-28.
[253] Exh. 530-1.
[254] Tr. 1386:12-18.
[255] Exh. 533-1.
[256] Consumer Watchdog's Post-Hearing Reply Brief, 13:17-14:6.

i. Trend Must Exclude Catastrophic Losses

It bears repeating that projected losses must exclude catastrophic losses. Having determined the December 2010 event constituted a catastrophe, and that catastrophic losses totaled $7,529,928, this amount must be removed from Mercury's projected losses. Only then may the proper trend calculations be made. In Exhibits 530 through 534, Consumer Watchdog correctly removed catastrophe losses and calculated the applicable trends. The ALJ used the trends in those exhibits as the basis for the table in Section 7.b. above, and in selecting the trends for the policy forms at issue.

ii. Regulation Permits Use of Different Trends for Different Policy Forms

Consumer Watchdog argues insurers must apply the same trend period to each policy form in a rate application. The CDI and Mercury disagree with Consumer Watchdog's interpretation. The Regulation does not specifically address the multi-policy form issue. But the Regulation does require an insurer to file its rate application with the most actuarially sound single data period.

When a single application contains three different rate requests, it is prudent to consider the overall impact of the rate application. In this instance, Mercury's rate application includes three separate policy forms and rates for each form are generated separately. Each policy form calculates its own average catastrophe factor, loss development and trend. These separate calculations speak to the distinct nature of the insured risk under each policy form.

Given the diverse nature of the risk under these policy forms, the most actuarially sound single data period for each policy form would not necessarily be identical. Thus, the ALJ finds the Regulations permit use of different trend periods for separate policy forms.

That said, based on the evidence presented, the ALJ concludes the most actuarially sound approach in this instance is to apply the same trend period to each of Mercury's three policy forms.

iii. 16 Point Trend Most Actuarially Sound for Policy Form HO-3

The ALJ concludes the 16 point loss trend of -0.4% balances the need for stability and yet is short enough to be responsive to recent economic developments. In so holding, the ALJ rejects Mercury's argument in favor of a longer trend period.

First, the ALJ finds support in the economic evidence provided. Xactware calculations show California's 2010 reconstruction cost index decreased by 1.5%. Similarly, California's 2011 reconstruction cost index grew by only 0.5%, while the national average grew 1.52%. And, Xactware's California Industry Trend Report shows virtually no increase in labor and materials costs from January 2009 to the present. These facts demonstrate a stagnant cost and labor index and support a loss trend of negative 0.4%.

While Mercury relies upon Dr. Appel's testimony in support of a longer trend period, the ALJ finds the California-specific evidence more compelling. Mercury advocates for a trend of 2.7% or 3.0% based on Dr. Appel's testimony regarding nationwide costs. Yet, the ALJ finds no evidence to support a finding that California's cost and labor index will increase by 3 percentage points; in fact Xactware's data shows quite the opposite.

Mercury also argues against the 16 point trend because it omits 2005 through 2007 data. While it is true a 16 point trend omits losses from 2005 through 2007 that is the nature of trend selection; some data will always be excluded in favor of a balanced approach. In fact, at the outset of this proceeding, all parties agreed that using a 16 point trend was the best fit. Mercury changed its argument only after it realized the removal of catastrophe losses produced a negative trend.

Lastly, California's economy from 2008 to the present is vastly different from its economy prior to 2008, when the housing and construction industry began to bottom out. Based on Xactware's Trend Report, there is little reason to believe the industry will increase drastically in the next few years. As such, inclusion of pre-recession data reflecting the construction boom tends to skew the trends and introduces fluctuations not expected to repeat in the near future.

iv. 16 Point Trend Most Actuarially Sound for Policy Forms HO-4 and HO-6

Policy forms HO-4 and HO-6 comprise a much smaller percentage of Mercury's homeowner's line. Because the amount of premium is smaller in these lines, Mercury has less loss data available upon which to make trend selections. Generally, when loss data is lacking insurers select a longer trend to smooth out loss distortions. However, the ALJ finds no support for a trend selection longer than 16 points.

Mercury's 20 and 24 point trend selections indicate Mercury's belief that repair costs will rise 10 to 13 percentage points over the next few years. As explained above, inclusion of pre-recession data tends to skew the trends and introduces fluctuations not expected to repeat. Even Dr. Appel's index calls only for a 4% increase in repair costs. Thus, Mercury fails to justify its 20 and 24 point trend selections.

The ALJ also concludes that the shorter 8 and 12 point trends selected by CDI and Consumer Watchdog are not actuarially sound. Short trends are heavily influenced by short-term fluctuations. And because these smaller policy forms generate less data, they are more susceptible to short-term fluctuations. Despite these certainties, both CDI and Consumer Watchdog advocate for short trend periods. The CDI relies upon decreasing loss ratios in support of its argument. While it is true that HO-4 loss ratios have steadily decreased over the last three years, such a decrease does not eliminate the volatility of an 8 or 12 point trend selection.

What remains is a 16 point trend selection that best balances the instability of small policy forms with future economic developments. Accordingly, the ALJ concludes a 16 point trend is the best fit for policy forms HO-4 and HO-6 and selections of 5.2% for policy form HO-4 and 9.3% for policy form HO-6 shall be applied to Mercury's rate application.

B. Projected Defense and Cost Containment Expenses

All insurers incur costs during the claim settlement process. The insurance industry classifies such costs, or loss adjustment expenses, as either defense and cost containment expenses (DCCE) or as adjusting and other expenses (A&O). An insurer's DCCE includes costs incurred in defending claims, such as expert witness fees, litigation management expenses as well as some attorney fees.[257] A&O include all other expenses. For ratemaking purposes, the Regulations consider projected DCCE with losses in the numerator of the rate formula.

[257] Werner & Modlin, Basic Ratemaking, p. 121.

1. Regulatory Formula & Applicable Law

Section 2644.8, subdivision (a) requires insurers to adjust DCCE for catastrophes, and develop and trend those expenses in the same manner as projected losses. The Commissioner provides insurers with three methods to develop projected DCCE. First, an insurer may develop DCCE separately from losses, using the same method proscribed for developing and trending projected losses. Second, an insurer may add DCCE to losses for development and trend. Third, DCCE may be developed using ratios of DCCE to losses.[258] In all three methods, an insurer must demonstrate its selection is the most actuarially sound.

2. Findings re: Mercury's DCCE Calculation and Development

A preponderance of evidence demonstrates the following facts with regard to Mercury's DCCE.

Mercury chose to develop its DCCE through the ratio method. First, Mercury developed and calculated its DCCE property and liability ratios from 2007 through 2011. From those five years, Mercury then calculated an average percentage of developed ultimate DCCE to losses. For form HO-3, Mercury calculated a ratio of 72.1% for liability and 7.7% for property. For form HO-4, Mercury's ratio equaled 16.8% for liability and 7.5 % for property, while the developed ultimate DCCE to losses for form HO-6 equaled 29.3% for liability and 9.0% for property.[259]

Mercury then calculated the total DCCE for the entire line by combining the liability and property ratios. In so doing, Mercury employed a complex formula to

[258] Cal. Code Regs., tit. 10, § 2644.8, subd. (b).
[259] Exh. 48-40; Exh. 49-40; Exh. 50-40.

determine its combined DCCE ratio. Having determined the combined DCCE ratio, Mercury then applied that ratio to its combined property and liability losses.

For policy form HO-3, Mercury's combined ratio totaled 11.7% resulting in more than $10.7 million in DCCE. Mercury's combined ratio for form HO-4 equaled 10.5% and resulted in $230,823 in DCCE. Mercury's combined ratio of 11.4% for form HO-6 gave rise to $771,243 in DCCE.

3. CDI's Contentions

The CDI does not dispute Mercury's selected DCCE method. Instead, the CDI takes issue with the time period and manner in which Mercury calculated the DCCE. The CDI finds two distinct flaws with Mercury's DCCE calculation. First, the Regulations do not permit Mercury's use of a five-year average DCCE ratio. Instead, the CDI claims the Regulations require data from the "Recorded Period;" the historical period that provides the basis for the proposed rate.[260] Unless otherwise unreliable, the recorded period shall be the most recent three years for which data is available.[261]

In addition, the CDI concludes that even if the Regulations permit the use of a five-year average, Mercury's method of combining the property and liability ratios to achieve an overall 11.7% ratio is unsound.[262] Because of the large difference between the DCCE ratios for property and liability losses, the CDI states it is critical to coordinate properly the property and liability losses with the correct DCCE percentage. In short, the CDI argues that Mercury's failure to apportion the DCCE property and liability losses accurately results in a combined ratio which overestimates DCCE losses.

[260] CDI's Post-Hearing Opening Brief, 20:8-12.
[261] Cal. Code Regs., tit. 10, § 2642.6.
[262] CDI's Post-Hearing Opening Brief, 22:4-7.

By way of explaining Mercury's allegedly misguided approach, the CDI notes that Mercury's five-year property losses totaled nearly $379 million while its total liability losses for the same period equaled only $25 million. At the same time, the ratio of DCCE to property losses equaled 7.7% while the ratio of DCCE to liability losses totaled 72.1%. Rather than simply using the DCCE ratio for property to calculate the total property DCCE and the DCCE ratio for liability to calculate the total liability DCCE, Mercury combined the property and liability DCCE ratios into an average ratio and applied that ratio to the recorded property and liability losses for one calendar year. Mr. Gammell believes this approach improperly increases the DCCE as it fails to account for the December 2010 catastrophic rain losses and assumes a static property/liability loss split.[263]

4. Mercury's Contentions

Mercury contends the Regulations permit use of a five-year average DCCE ratio. In support of this argument, Mercury points to the Regulations' language and Ms. Bass's testimony. Because Section 2644.8 does not provide a time period in which to calculate the average DCCE ratio, Mercury argues it may employ a five-year average. In addition, Ms. Bass testified use of a five-year average is the most actuarially sound means of estimating the ultimate DCCE dollars.[264] Mercury relies upon this testimony to support its five-year average.

Mercury also claims it appropriately combined DCCE liability and property percentages. Mercury acknowledges that its statement presumes the December 2010 losses were not catastrophic and may, therefore, be an imperfect approach. But Mercury

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[263] *Id.* at 24:1-18.
[264] Mercury's Post-Hearing Opening Brief, 63:9-16.

relies on the testimony of its actuaries to support this approach. Mercury argues that because Ms. Bass and Ms. Gao, both of whom are actuaries, approved Mercury's approach, Mercury's method is the most actuarially sound.[265]

5. Analysis and Conclusions re: Proper DCCE Calculation

Having considered the facts and arguments presented, the ALJ concludes the Regulations do not permit the use of a five-year average ratio. The ALJ concludes the most actuarially sound method of applying DCCE ratios to losses is a simple, additive approach that removes catastrophe losses. Such an approach results in DCCE HO-3 losses of $9,847,141; the amount calculated by Consumer Watchdog.

a. Catastrophic Losses Must Be Removed From DCCE

Catastrophic events can cause extraordinary loss adjustment expenses. For example, in the event of a major catastrophe, a company may have to set up temporary offices in the catastrophe area. To the extent that those costs are significant and irregular, the historical ratio will be distorted. Thus, catastrophe loss adjustment expenses are excluded from the standard DCCE analysis and are determined as part of the catastrophe provision.

In calculating its ultimate HO-3 losses, Mercury included $7.6 million in catastrophic losses. Removing those catastrophic losses alters Mercury's historic HO-3 losses to $83,973,043.

b. The Additive Method Is the Most Actuarially Sound

Using the third method set forth in the Regulations, Mercury combined its property and liability ratios into one ratio and applied that joint ratio to its losses for the

[265] Mercury's Post-Hearing Reply Brief, 14:7-13.

recorded period. The ALJ finds this approach unnecessarily complicated and its results inaccurate.

The imprecise nature of Mercury's method is best illustrated by demonstrating its results. For HO-3, Mercury calculated an average ratio of 72.1% for liability and 7.7% for property. In addition, Mercury's ultimate losses equaled $101,671,000, of which $97,062,000 were property losses and $4,610,000 were liability losses. Through a complicated method, Mercury calculated a combined DCCE ratio of 11.7%. Multiplying Mercury's ultimate losses of $101,671,000 by the combined DCCE ratio of 11.7%, results in DCCE of $11,895,507.

Applying an additive approach results in a markedly different DCCE. Multiplying Mercury's property losses of $97,062,000 by the property DCCE ratio of 7.7%, results in $7,473,774. Multiplying Mercury's liability losses of $4,610,000 by the liability DCCE ratio of 72.1%, results in $3,323,810. Adding those DCCE figures results in an ultimate DCCE of $10,797,584; $1 million less than the amount calculated by Mercury.[266]

Based on the above examination, the ALJ concludes Mercury's method results in an erroneous DCCE calculation. The simple, additive approach the CDI champions is a more accurate DCCE calculation and is the most actuarially sound.

c. Regulations Do Not Permit Use of a Five-Year Ratio

Mercury argues Section 2644.8's silence constitutes approval of a five-year average, but Mercury fails to consider all of the Regulation's language as well as the overall regulatory intent.

Regulation 2644.8 requires the insurer to develop and trend DCCE payments in the same manner as it developed and trended losses. Since insurers must develop and

[266] $3,323,810 + $7,473,774 = $10,797,584.

trend losses over the three-year "recorded period," the ALJ concludes a three-year average, rather than a five-year average, is more consistent with the intent of section 2644.8.

A review of the entire ratemaking process also supports the ALJ's conclusion. Similar to losses, DCCE payments represent expenses incurred during the claims adjusting process. And, as explained above, the Regulation subjects DCCE payments to the same recorded period. Mercury's use of a five-year average DCCE ratio allows the insurer to bring in DCCE experience from outside the recorded period. One can easily imagine cases of potential abuse if outside experience were permitted. For example, a company that experienced a high DCCE to loss ratio the year before the recorded period would certainly advocate for an extended time period in order to include its "bad" experience into the ratemaking formula. Instead, the ALJ concludes a more reasoned approach requires DCCE payments to mirror the time period employed for losses; the three-year recorded period.

Having calculated Mercury's three-year average DCCE ratios from the amounts provided in Mercury's rate application, the ALJ finds Mercury's proper HO-3 liability ratio equals 83.8% and its property ratio equals 8.6%.[267] However, altering these ratios has little impact on the correct DCCE amount, which equals $9,847,141 for policy form HO-3. The ALJ's calculations are shown in Appendix 3 of this decision.

C. Efficiency Standard

The Insurance Commissioner annually sets the efficiency standard, which represents the fixed and variable costs for a reasonably efficient insurer to provide

[267] See Appendix 3 of this Proposed Decision.

insurance and to render good customer service.[268] The efficiency standard is expressed as a maximum allowable ratio of historic underwriting expenses to historic earned premiums for each insurance line. For calendar year 2010, the Commissioner set the efficiency standard for homeowner lines at 37.12%.

The Commissioner's efficiency standard may be modified, however, based on an insurer's excluded expense factor; the ratio of an insurer's national excluded expenses to its national direct earned premium. California Regulations prohibit an insurer from passing on the costs of certain expense items to ratepayers.[269] Those insurers who attempt to pass on such excluded expenses find their efficiency standard reduced. Included among those excluded expenses are excessive executive compensation, political contributions and lobbying expenditures, institutional advertising costs, fines and penalties, and all payments to affiliates that exceed fair market value. Increasing an insurer's excluded expense factor generally results in a lower overall indicated rate.[270]

Of the excluded expenses listed by the Commissioner, the parties disagree only on whether to remove Mercury's political contributions and advertising expenses from its stated costs.[271] Removal of these expenses results in an increased excluded expense factor and a lower efficiency standard.

1. Political Contributions and Lobbying Costs

The parties do not dispute that political contributions and lobbying costs made by an insurance carrier must be excluded from the ratemaking formula. The issue remains what portion of the political contributions came from insurance affiliates.

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[268] Cal. Code Regs., tit. 10, § 2644.12, subd. (a).
[269] Cal. Code Regs., tit. 10, § 2644.10.
[270] Tr. 482:11-483:5.
[271] The parties no longer dispute that $370,000 in fines must be allocated to Mercury's excluded expenses.

a. Regulatory Formula & Applicable Law

The Commissioner's regulation prohibits passing on "political contributions and lobbying" expenses.[272] The Regulation does not define political contributions or lobbying expenses. Accordingly, the ALJ will apply the generally accepted definition of these terms.[273] In addition, the Regulation is silent with regard to contributions made by affiliated non-insurance entities.

b. Findings re: Mercury's Political Expenditures in Recorded Period

The ALJ finds by a preponderance of evidence the following facts regarding Mercury's political expenditures during the recorded period.

Mercury General Corporation is the parent company for Mercury Casualty and 21 other entities. Mercury General provides no services to customers and receives all its operating resources directly from its insurance affiliates, most notably Mercury Casualty.[274] Concord Insurance Services is a Texas-based, non-operative affiliate of Mercury General. At the time Concord ceased operations in 2006, Concord's common stock was valued at $2,000. Mercury General then contributed $11.6 million to Concord in the form of additional capital.[275] Concord retained that additional capital and used that money to make its political contributions in 2009 and 2010.[276]

In 2009, Mercury General Corporation and Concord Insurance contributed more than $3.6 million to California campaigns. Mercury spent $3.5 million of the $3.6 million on Proposition 17; Mercury's California ballot initiative aimed at amending the rate

[272] Cal. Code Regs., tit. 10, § 2644.10, subd. (a).
[273] *In the Matter of the Rate Application of Allstate Insurance Company, supra*, PA-2006-00006 at p. 12.
[274] Tr. 987:6-10.
[275] Exh. 76-2; Tr. 994:13-995:3.
[276] Tr. 995:14-24.

regulations under the Insurance Code.[277] In 2010, Mercury General and Concord contributed another $14.5 million to California campaigns, at least $10 million of which supported Proposition 17.

In 2010, the Mercury Insurance Group donated $327,589 to Proposition 17.[278] The Mercury Insurance Group is a business name used by Mercury and is not an organized legal entity in any state.[279] In fact, this contribution came from Mercury's insurance affiliates.[280] Mercury also belatedly identified lobbying expenses paid by Mercury insurance affiliates totaling approximately $200,000 for each of the calendar years 2008, 2009 and 2010.[281]

Mercury also acknowledged contributions to the Personal Insurance Federation of California (PIFC); a six-member organization engaged in legislative, regulatory and legal advocacy on behalf its members. Comprised of six of the largest California insurers, the PIFC's staff and lobbyists communicate with the CDI and California legislators on issues important to the insurance industry.[282] In September 2010, Mercury Insurance Services, LLC, the affiliated management company for Mercury General, issued the PIFC a check for $220,479.34.[283] According to the PIFC invoice, of the $222,000 paid to PIFC, 8%, or $17,638, constituted lobbying expenses.[284] In July 2011, Mercury Insurance Services, LLC issued a check for $220,000 to the Personal Insurance Federation Committee, a registered political action committee affiliated with PIFC.[285] The cancelled checks show

[277] Exh. 74.
[278] Exh. 74-19; 74-20.
[279] Tr. 1027:14-17.
[280] Tr. 1029:1-20.
[281] Exh. 74-59 through 74-66; Yeager PDT, 7:7-10.
[282] Exh. 553.
[283] Exh. 114.
[284] Exh. 74-54.
[285] Exh. 115.

PIFC deposited Mercury's first check in its general operating account, but placed Mercury's 2011 check for $220,000 directly into the political action committee's bank account.

Mercury's 2010 Annual Report also acknowledges Mercury's significant political contributions. The Annual Report notes the "Company" made financial contributions of $12.1 million and $3.5 million in 2010 and 2009, respectively, to further Proposition 17.[286] Mercury also concedes its political contributions had a significant impact on its combined ratio.

> The reduction in operating earnings was primarily due to the deterioration of the combined ratio from 96.9% in 2009 to 100.7% in 2010. The increase in the combined ratio was primarily the result of $9 million of increased expenses incurred to support California's Proposition 17 . . .[287]

The combined ratio is the sum of the ratio of losses to premium and the ratio of expenses to premium. All parties agree it is a term of art specific to the insurance industry.[288]

c. Mercury's Contentions

Mercury asserts political expenditures in 2009 and 2010 were made by Mercury General and Concord Insurance Services, Inc., both non-insurance entities. As such, Mercury Casualty may charge these expenses to ratepayers as part of this rate application.[289] In support of this argument, Mercury submitted cancelled checks which show the payor of the contributions.

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[286] Exh. 505-6.
[287] Exh. 505-2.
[288] Tr. 235:9-12; Tr. 395:19-22; Tr. 996:18-20.
[289] Mercury's Post-Hearing Opening Brief, 49:1-5.

Mercury also contends it did not allocate monies paid to PIFC to any insurance affiliates.[290] Mercury submitted a cancelled check from Mercury Insurance Services' account which demonstrates the management company made the PIFC payment. In addition, Mercury provided testimony from Mr. Yeager, Mercury's Controller, who testified Mercury General reimbursed the management company for the $17,638 in lobbying fees.[291] In addition, Mercury states payments made during fiscal year 2011-2012 are not properly considered in this rate application.[292]

d. Consumer Watchdog's Contentions

Consumer Watchdog argues there is sufficient evidence to conclude Mercury's insurance affiliates made political expenditures during the recorded period. In support of this contention, Consumer Watchdog relies upon Mercury's use of the term "combined ratio" as well as the PIFC payments.

Consumer Watchdog opines that Mercury insurance affiliates paid at least some portion of the political expenditures, given the payments' impact on the combined ratio.[293] Consumer Watchdog notes that "combined ratio" is a term of art that necessarily refers to insurance companies. Thus, Mercury's use of the term in its Annual Report demonstrates Mercury's insurance affiliates made at least some of the political payments.

Consumer Watchdog also argues payments made by Mercury to the PIFC must be removed from the rate application. Consumer Watchdog notes that PIFC is an advocacy

[290] *Id.* at 49:20-50:6.
[291] Yeager's Testimony in Response to ALJ's April 11, 2012, Order (Yeager ALJT), 3:17-20.
[292] Mercury's Post-Hearing Opening Brief, 50:7-12.
[293] Consumer Watchdog's Post-Hearing Opening Brief, 22:1-6.

and political action group and all its activities focus lobbying.[294] Accordingly, all monies provided to PIFC must be excluded from Mercury's rate application.

e. Analysis and Conclusions re: Mercury's Political Expenditures

Having considered the facts and legal arguments, the ALJ concludes that Mercury's rate application must show as excluded expenses political expenses and lobbying payments of $183,326 for 2008,[295] $210,656 for 2009[296] and $528,015 for 2010.[297]

i. Use of the "Combined Ratio" Not Dispositive of the Issue

Consumer Watchdog asserts Mercury's use of the term "combined ratio," in conjunction with a discussion about its political expenditures, means Mercury's insurance affiliates made the political payments. In response, Mercury states use of the term "combined ratio" does not mean every detail in the Annual Report is attributable to every Mercury affiliate, because Mercury's Annual Report is a consolidated report of Mercury's operations.[298]

Since publicly filed documents demonstrate Mercury made most of its political contributions through Concord Insurance or Mercury General Corporation, Mercury's use of the term combined ratio appears to be nothing more than careless wording.

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[294] Schwartz PART, 13:21-24.
[295] Lobbying fees of MCC and MIC ($99,996 + $83,330 = $183,326).
[296] Lobbying fees of MCC and MIC ($100,713 + $100,943 = $210,656).
[297] Lobbying and political expenditures ($100,213 + $100,213 + $327,589 = $528,015).
[298] Mercury's Post-Hearing Reply Brief, 13:8-10.

ii. Contributions Made by Non-Insurance Entities Are Permissible

Funds used by Mercury General Corporation and Concord Insurance Services to finance Proposition 17 originated with Mercury Casualty in the form of a dividend. Nonetheless, the Regulations exclude only those political expenses paid for by, or allocated to, insurance entities. Thus, only those payments made by Mercury Casualty or other insurance affiliates may be excluded.

In 2008, Mercury insurance affiliates paid lobbying expenses totaling $183,226. Similarly, in 2009 Mercury insurance companies incurred lobbying costs of $201,656. There is no argument that such expenses must be excluded from the rate application. In 2010, Mercury insurance affiliates spent $200,426 in lobbying costs. In addition, the Mercury Insurance Group made political contributions in the amount of $327,589 to Proposition 17. As this money originated with insurance affiliates, it too must be excluded. Thus, the total 2010 political and lobbying costs, excluding PIFC expenditures, equals $528,015.[299]

iii. PIFC Expenditures Need Not Be Excluded

Examination of PIFC's website confirms that the organization's aim is political action. Any current or future payments made to PIFC by an insurance entity must be excluded from the rate application. But such a conclusion does not render Mercury's 2010 PIFC contributions excludable. Mercury allocated its 2010 PIFC contribution to

[299] That said, the ALJ has concerns about using an affiliated corporate instrumentality pass on excluded expenses. As noted above, Mercury General does not provide any services to consumers and serves only as the parent company for Mercury Casualty and other affiliated insurers. All monies received by Mercury General come in the form of dividends issued by the insurance affiliates. Shifting these monies to Mercury General allows the insurer to pass on otherwise excluded political expenditures to ratepayers. The ALJ believes that permitting conveyance of such monies defeats the purpose and intent of the Regulation and improperly increases the indicated rate.

Mercury General, and not an insurance affiliate. Thus, the ALJ will not include Mercury's 2010 PIFC payment in Mercury's excluded expense factor.

2. Institutional Advertising Expenses

The parties also disagree as to whether Mercury's advertising expenses must be removed from the rate application.

a. Regulatory Formula & Applicable Law

The rate chargeable to consumers may only include expenses necessary in the offering of an insurance product or that in some way provide them a benefit.[300] The Commissioner has determined that "institutional advertising" provides no benefit to the consumer and instead benefits a company's shareholders. Thus, such advertising is excluded from the rate application.

The Regulation defines "institutional advertising" as advertising 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.[301] Put differently, institutional advertising is "image" advertising which strives to enhance a company's reputation or improve corporate name recognition.[302] Such advertising does not promote a specific product or service but instead attempts to obtain favorable attention to the company as a whole.[303] In fact, institutional advertising is especially cost-effective for corporations with a series of products, because such advertising transfers its influence to

[300] *In the Matter of the Rate Application of Roseville Telephone* (1996) 70 Cal.P.U.C.2d 88, 122.
[301] Cal. Code Regs., tit. 10, § 2644.10, subd. (f).
[302] Arens, Contemporary Advertising (13th ed. 2011) pp. 632-665.
[303] *Id.* at p. 700.

all of a company's products, whereas product advertising affects only the purchase of the exact product.[304]

Event sponsorship is a common form of institutional advertising. Sponsorship improves public relations by affiliating the company with a worthy cause while simultaneously improving a company's bottom line.[305] Other examples of institutional advertising include display of company logos, promotion of a company's environmental efforts, or campaigns against cell phone use while driving. In the regulatory arena, this type of corporate advertising is consistently excluded from ratemaking formulas since it benefits mainly the shareholders and not the ratepayers.[306]

b. Findings re: Mercury's Advertising Expenditures

A preponderance of the evidence establishes the following facts with regard to Mercury's advertising expenditures and methods.

Mercury General and all its affiliates advertise under the name "Mercury Insurance Group." The Mercury Insurance Group is not a legal entity in any state and not a licensed insurer in California. Mercury General's advertising department supports all of Mercury's affiliates and Mercury guides all its prospective customers to one telephone number.[307] Mercury does not allocate advertising expenditures to specific insurance affiliates nor does the advertising department distinguish between insurance entities when

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[304] Kim, Sora et al., *Comparison of the Paths From Consumer Involvement Types to Ad Responses Between Corporate Advertising and Product Advertising*, 38(3) Journal of Advertising 67-80.
[305] Arens, Contemporary Advertising, *supra* at p. 648. See also, Schumann, David et al., *Corporate Advertising in America*, 20(3) Journal of Advertising 35-56.
[306] See *In the Matter of the Rate Application of Roseville Telephone* (1996) 70 Cal.P.U.C.2d 88, 119-122; *Boston Gas Co. v. Dept. of Public Utilities* (1989) 539 N.E.2d 1001; *Public Serv. Com. of N.Y. v. Fed. Energy Reg. Com.* (D.C. Cir. 1987) 813 F.2d 448.
[307] Tr. 736:2-5.

generating advertising campaigns.[308] All Mercury companies share a common website which identifies the company as Mercury Insurance Group.

In 2008, 2009 and 2010, Mercury General Corporation's advertising expenses totaled $26 million, $27 million and $30 million respectively.[309] Mercury allocates its advertising budget among a variety of media, including television, radio, direct mail and sports sponsorship. Mercury's Annual Report states the company "believes that its advertising program is important to create brand awareness and to remain competitive in the current insurance climate."[310]

In 2008 and 2009 combined, Mercury spent over $1 million in sports sponsorship.[311] That amount was eclipsed by Mercury's 2010 sponsorship expenses, which totaled over $1.1 million. Much of the 2010 sporting event costs can be attributed to Mercury's sponsorship of the Mercury Open, a professional tennis tournament held in California. In summarizing its funding of the tennis tournament, Mercury acknowledged the event bought the company goodwill and provided innumerable public relations benefits:

> This event was solely focused on the Mercury brand. We were able to integrate our logo into the event's logo, so that everything connected to the tournament included Mercury branding and messaging. This was especially important, as it greatly increased awareness of Mercury's products and services within the tennis community.[312]

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[308] Tr. 727:12-23.
[309] Exh. 505 – 507.
[310] Exh. 505-5.
[311] Exh. 67.
[312] Exh. 70-195.

c. Mercury's Contentions

Mercury states the company aims all its advertising at obtaining business for each of Mercury's insurance companies.[313] Although all advertisements contain the name Mercury Insurance Group, Mercury contends the advertisements are nonetheless targeted to specific insurance affiliates, since they direct customers to Mercury's website.[314]

Mercury also argues that requiring insurers to advertise for a "specific insurer" is illogical and arbitrary because it penalizes group insurers.[315] Mercury contends such an interpretation means affiliated insurers can no longer operate under a group name and results in inefficient operations.[316]

Lastly, Mercury argues the Commissioner should interpret the Regulation to permit either (1) advertising aimed at obtaining business for a specific insurer, or (2) advertising that provides customers with pertinent information regarding an insurer's product.[317]

d. Consumer Watchdog's Contentions

Consumer Watchdog cites Mercury's advertising campaigns and Mercury's own statements as evidence that all of Mercury's advertising is institutional advertising. First, Consumer Watchdog notes Mercury advertises under a fictitious business name and does not intend to advertise for specific insurers.[318] Second, Consumer Watchdog points out that Mr. Thompson, Mercury's Advertising Director, specifically stated Mercury's advertisements were not intended to generate business for a specific insurer.[319] Third,

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[313] Mercury's Post-Hearing Opening Brief, 51:12-13.
[314] *Id.* at 52:6-9.
[315] *Id.* at 56:14-25.
[316] *Id.* at 57:5-21.
[317] *Id.* at 51:9-11.
[318] Consumer Watchdog's Post-Hearing Opening Brief, 18:19-19:2.
[319] *Id.* at 19:18-24.

Consumer Watchdog concludes that many of Mercury's advertisements did not provide information pertinent to the decision to buy insurance and instead focused on branding.[320]

e. Analysis and Conclusions re: Advertising Expenses

Mercury defines institutional advertising as advertising that is not designed to generate business or provide customers with information.[321] This definition of institutional advertising is both narrow and impracticable, and would render all advertising expenses chargeable to the ratepayer; a fact Mercury concedes.[322] Instead, the Regulation permits only advertising that seeks to obtain business for a specific insurer and also provides customers with pertinent information. As Mercury's aims its entire advertising budget at promoting the Mercury Group as a whole, the ALJ concludes that Mercury's entire advertising expenditures must be removed from the ratemaking formula.

i. Mercury's Ads Do Not Seek Business For a Specific Insurer

Mercury admits its advertising does not seek to obtain business for a specific insurer.[323] In fact, Mr. Thompson acknowledges that all of Mercury's advertising is designed for the insurance group and not for a specific affiliate or company within Mercury.[324] This fact is further confirmed when analyzing Mercury's advertisements. Both print and radio advertisements urge consumers to contact the "Mercury Insurance Group" through a common website and telephone number. Consumers do not contact the specific insurance affiliates directly, nor do any of Mercury's specific insurers engage in their own advertising.[325] While Mr. Thompson argues the advertising is "insurance"

[320] *Id.* at 19:24-20:9.
[321] Tr. 726:10-14.
[322] Tr. 726:21-25.
[323] Tr. 735:7-10; Tr. 737:11-18.
[324] Tr. 730:15-23.
[325] Tr. 728:22-25.

specific, the Regulation requires the promotion be aimed at generating business for a specific insurer, not a specific industry.

ii. "Mercury Insurance Group" Is Not a Specific Insurer

Nor can Mercury argue that the "Mercury Insurance Group" is a specific insurer. The Mercury Insurance Group is not a legal entity, nor is there any consensus as to the makeup of the Mercury Insurance Group. Mr. Thompson testified the Mercury Insurance Group is comprised of Mercury Casualty, Mercury Insurance Company and California Automobile.[326] But Mr. Yeager testified the Mercury Insurance Group includes all 22 legal entities that make up the consolidated Mercury General Corporation.[327] What is certain is that Mercury General does not advertise for its specific insurers and instead engages in advertising on behalf of the organization as a whole.

iii. ALJ's Interpretation Consistent with Statutory Intent

Mercury urges the Commissioner to interpret "specific insurer" to mean "a specific group of affiliated insurers."[328] Yet such an interpretation is contrary to the clear regulatory intent and inconsistent with the purpose of provision.

The rules governing statutory interpretation also apply to the Commissioner's Regulations. The first rule in statutory construction requires the interpreter to examine the regulation's language. If the regulation's words, given their usual and ordinary meaning

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[326] Tr. 748:3-7.
[327] Tr. 1026:20-24.
[328] Mercury's Post-Hearing Opening Brief, 57:16-21.

and read in context, are clear and unambiguous, the conclusion must be that the adopting authority meant what it said, and the plain meaning of the regulation applies.[329]

Regulation 2644.10, subdivision (f) contains clear and unambiguous language. The Regulation defines institutional advertising as advertising not aimed at obtaining business for a specific insurer. Had the Commissioner intended to charge consumers for affiliate or group advertising, he could have eliminated the reference to "a specific" insurer. But the Commissioner decision to include the "specific insurer" requirement renders the Regulation's meaning unmistakable. Advertising which generates business for a group of insurance companies, regardless of affiliation, is not advertising for a specific insurer.

Mercury also argues the Regulation is arbitrary. Mercury contends there is no logical reason to penalize an insurer for advertising under a group insurance name.[330] But such an argument is defeated when one considers the Regulation's intent. Consumers are obligated to pay only expenses necessary in the offering of an insurance product or that in some way provide them a benefit.[331] Mercury may not charge consumers for advertising that promotes corporate identity, enhances public opinion, or increases name and brand awareness. Mercury chose to direct its advertising budget towards its entire group of affiliates. In so doing, Mercury does not distinguish between those expenses chargeable to Mercury Casualty customers and those chargeable to affiliated ratepayers. As such, Mercury cannot require its Mercury Casualty policyholders to fund its advertising for other Mercury companies. In addition, Mercury does not explain why Mercury Casualty

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[329] *Prachasaisoradej v. Ralphs Grocery Co., Inc.* (2007) 42 Cal.4th 217, 227; *Dep't of Alcoholic Beverage Control v. Alcoholic Beverage Control Appeals Bd.* (2003) 109 Cal.App.4th 1687, 1696.
[330] Mercury's Post-Hearing Opening Brief, 56:14-25.
[331] *In the Matter of the Rate Application of Roseville Telephone* (1996) 70 Cal.P.U.C.2d 88, 122.

policyholders, as opposed to shareholders, should shoulder the expense of advertising for Mercury General since that does not benefit them in any fairly discernible and direct way.[332] This failure means Mercury's entire advertising budget must be excluded from the rate application.

iv. ALJ's Interpretation Consistent with Case Law

Mercury's argument also fails to consider the rulings of other agencies and jurisdictions. Both California and federal courts consistently interpret "institutional advertising" to exclude affiliate or other image building advertising.

A large number of California Public Utilities Commission (CPUC) decisions address the issue of institutional advertising. In the area of affiliate advertising, *In the Matter of the Rate Application of Roseville Telephone Company* serves as the CPUC's seminal case. Therein, the CPUC reviewed the advertising expenditures of the Roseville Communication Corporation, a group of affiliated companies. Included in that group was Roseville Telephone. The CPUC noted that the parent corporation, RCC, took out a full page advertisement on the back cover of the Roseville Telephone directory. The advertisement featured the names and logos of various RCC subsidiaries and non-regulated businesses. RCC charged the entire cost of the advertisement to Roseville Telephone. But the CPUC held that the display of affiliated company names and logos constitutes institutional advertising and excluded such advertising from RCC's rate application.[333]

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[332] *Boston Gas Co. v. Dep't of Pub. Utilities* (1989) 539 N.E.2d 1001, 1004.

[333] *In the Matter of the Rate Application of Roseville Telephone Company* (2001) 2001 Cal.PUC LEXIS 604, 43-45; See also, *In the Matter of the Rate Application of California Water Service* (2003) 228 P.U.R.4th 204, 65-67.

Federal authorities also exclude image or promotional advertising expenses from rate applications. In *Public Service Commission of State of N.Y. v. Federal Energy Regulatory Commission*, the Tennessee Gas Pipeline Company filed several general rate filings with the FERC. Tennessee Gas included as its own expenses, a portion of its parent corporation's image advertising costs.[334] These advertisements promoted the parent company's image as a solid, growing company. The FERC excluded the corporate advertising costs, and held Tennessee Gas failed to show that its rate payers benefited from such image advertising.[335]

v. Regulation Does Not Result in Increased Costs

Mercury also contends the regulation's language destroys affiliated insurance groups.[336] Mercury argues insurers will be forced to advertise separately for each of its affiliated subsidiaries, thereby increasing the cost of insurance. But Mercury's argument again disregards the Regulation's intent.

The Regulation does not regulate the content or form of advertising; only what expenses may be passed on to the consumer. Associated insurers may advertise in any manner they choose. But, if an insurer spends advertising dollars on institutional advertising, rather than on advertising for specific insurers, the insurance company may not charge such advertising expenditures to its policyholders. Mercury chose to advertise as the Mercury Insurance Group. As a consequence, the Regulation requires Mercury remove such advertising expenses from its rate application.

Competitor's rate applications further refute Mercury's argument. State Farm Insurance's most recent rate application identifies significant institutional advertising

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[334] *Public Serv. Com. of N.Y. v. Fed. Energy Reg. Com.* (D.C. Cir. 1987) 813 F.2d 448, 454.
[335] *Id.* at 456.
[336] Mercury's Post-Hearing Opening Brief, 57:5-9.

expenses.[337] State Farm is a mutual company comprised of affiliated insurance and financial services companies. Between 2008 and 2010, State Farm spent nearly $300 million on group advertising. Despite removing such institutional advertising expenses from its rate application, State Farm Insurance remains the largest insurer of cars and homes in the United States. Likewise, Travelers Indemnity's 2012 rate application notes over $150 million in corporate advertising expenses for its entire insurance group without any evidence of cost inefficiencies.[338] The ALJ finds similar results when analyzing the rate applications of The Hartford Insurance Group, Zurich American and Liberty Mutual, all of which exclude substantial institutional advertising expenditures.[339]

Given evidence that Mercury's competitors successfully obey the intent and language of the Regulation, the ALJ rejects Mercury's claim that strict adherence would eliminate insurance groups.

vi. Mercury's Advertising is Devoid of Pertinent Information

Even assuming Mercury Insurance Group constituted a "specific insurer," Mercury fails to demonstrate significant portions of its advertising provided consumers with pertinent insurance information.

Initially, Mercury attempts to alter the plain meaning of the Regulation by reinterpreting the provision. Advertising aimed at obtaining business for a specific insurer and that provides consumers with information pertinent an insurer's product may be charged to consumers. Yet Mercury argues it may charge policyholders for advertising aimed at obtaining business for a specific insurer or that provides consumers with

[337] CDI Rate Application No. 11-7257.
[338] CDI Rate Application No. 12-3614.
[339] Zurich American, CDI Rate Application No. 12-3673; Hartford Insurance, CDI Rate Application No. 12-4514; Liberty Mutual Insurance, CDI Rate Application No. 11-6339.

relevant information.[340] Contrary to Mercury's assertion, the ordinary and usual usage of "and" is as a conjunctive, meaning "also" or "plus."[341] It is the function of the word "or" to mark an alternative such as "either this or that."[342] Thus, advertising which fails to provide consumers with information pertinent to an insurer's product is also properly considered institutional advertising regardless of whether it is aimed at a specific insurer.

Mercury also asserts all its advertising provides customers with pertinent information. Yet, Mercury's sports sponsorship advertising demonstrates quite the opposite. Mercury's advertising includes the display of Mercury Insurance Group's logo on the sides of hockey rinks and baseball stadiums. The display of Mercury's logo does not provide consumers with pertinent information. Likewise, sponsorship of a professional tennis tournament does not provide consumers product information. Indeed, Mercury acknowledges that such advertising creates "brand awareness." While Mercury may provide informational materials to some sports patrons, the advertising campaign is primarily designed to enhance Mercury's corporate image, and thus must be excluded.[343]

There is no doubt that Mercury seeks to gain additional business in each of its advertising forums. But that end goal does not transform brand or goodwill advertising from an excludable shareholder cost to includable ratepayer expenditure. Since Mercury's aim is to generate business for the company itself and not for a specific product or insurance affiliate, Mercury's entire advertising budget must be excluded from the rate application. Accordingly, Mercury's calculated excluded expense factor shall include $26 million for 2008, $27 million for 2009 and $30 million for 2010.

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[340] Mercury's Post-Hearing Opening Brief, 51:9-11.
[341] *In re C.H.* (2011) 53 Cal.4th 94, 101.
[342] *In re Jesusa V.* (2004) 32 Cal.4th 588, 622.
[343] *In the Matter of the Rate Application of Pacific Telephone & Telegraph* (1974) 77 Cal.P.U.C. 117.

3. Applicable Excluded Expense Factor and Efficiency Standard

The ALJ calculated the ratio of premiums to excluded expenses in order to determine the proper excluded expense factor for each year.[344] Thereafter, the ALJ combined the three yearly factors to determine the three year average excluded expense factor. Based on the above excluded expenses, the ALJ concludes the proper three year average excluded expense factor equals 1.30%. Subtracting the excluded expense factor of 1.30% from the efficiency standard of 37.12% results in a new efficiency standard of 35.82%. This new efficiency standard of 35.82% must be applied to Mercury's rate application. Appendix 4 of this decision displays the ALJ's calculations.

C. Maximum Permitted Earned Premium

Based on the above calculated projected losses, catastrophe adjustment, trends and losses development factors, DCCE and efficiency standard, the ALJ concludes Mercury's maximum permitted indicated rate for each policy form, absent variances, equals as follows: (1) For policy form HO-3, the maximum indicated rate equals -8.18%, as shown in Appendix 5 to this Decision; (2) for policy form HO-4, the maximum indicated rate equals 4.32%, as shown in Appendix 6 to this Decision; and for policy form HO-6, the maximum indicated rate equals 29.44%, as shown in Appendix 7 of this Decision.

II. Variance (f)(3) – Leverage Factor Variance

For ratemaking purposes, the leverage factor is the ratio of earned premium to the average of year-beginning and year-end surplus.[345] Calculated by the Commissioner, leverage factors are based on industry-wide data and are established annually for each

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[344] See Appendix 4 to this Proposed Decision.
[345] Cal. Code Regs., tit. 10, § 2644.17, subd. (a).

insurance line.[346] For calendar year 2010, the homeowner's leverage factor applicable to Mercury's rate application was 1.27.

A. Regulatory Formula & Applicable Law

An insurer may be authorized to apply a leverage factor different from the one determined by the Commissioner on the basis that:

> [T]he insurer either writes at least 90% of its direct earned premium in one line or writes at least 90% of its direct earned premium in California and its mix of business presents investment risks different from the risks that are typical of the line as a whole.[347]

Accordingly, an insurer must initially demonstrate it writes at least 90% of its direct earned premium in one insurance line or demonstrate it writes at least 90% of its direct earned premium in California. If an insurer satisfies the initial requirement, it must then satisfy a second requirement of demonstrating its mix of business presents unique investments risks different from those normally presented by the insurance line as a whole.

A multi-line insurer cannot satisfy the initial requirement of Section 2644.27, subdivision (f)(3) by proving it writes at least 90% of one of its multiple lines of insurance in California.

If an insurer satisfies both requirements, the leverage factor is adjusted by multiplying it by 0.85. In addition, the surplus ratio shall be divided by 0.85. The impact of this variance is to increase the indicated rate.[348]

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[346] Cal. Code Regs., tit. 10, § 2644.17, subd. (b).
[347] Cal. Code Regs., tit. 10, § 2644.27, subd. (f)(3).
[348] Appel PDT, 6:11-12.

B. Findings re: Direct Earned Premium & Mix of Business

The ALJ finds by a preponderance of the evidence the following facts with regard to Mercury's direct earned premium and mix of business.

Mercury's 2010 total countrywide direct earned premium equaled $693,085,902. Of that $693 million, $213,507,728 was direct earned premium from Mercury's homeowner's line of business.[349] Thus, Mercury wrote 30.80% of its direct earned premium in its homeowner's line.

Mercury's 2010 California direct earned premium totaled $604,929,469.[350] Based on Mercury 2010 countrywide direct earned premium, Mercury wrote 87.28% of its direct earned premium in California.

C. Mercury's Contentions

1. Direct Earned Premium

Mercury argues it wrote 94.8% of its homeowner's line of business in California.[351] Mercury compared its countrywide homeowner's direct earned premium of $213,507,728 with its California homeowner's direct earned premium of $202,409,931 to reach this percentage.[352]

2. Mix of Business

Mercury also states its mix of business presents investment risks different from the risks that are typical of the line as a whole.[353] In support of this argument, Mercury notes its homeowner's line of business is highly concentrated in California. As such, it is subject to higher capital requirements.

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[349] Exh. 522-4.
[350] Exh. 522-5.
[351] Mercury's Post-Hearing Opening Brief, 79:10-13.
[352] Exh. 522-4.
[353] Mercury's Post-Hearing Opening Brief, 79:17-80:2.

D. CDI and Consumer Watchdog's Contentions

1. Direct Earned Premium

Both CDI and Consumer Watchdog argue Mercury misinterprets the Regulation by calculating the percentage of Mercury's homeowner's business written in California.[354] Instead, both parties argue, the variance requires an insurer to demonstrate it writes either (1) 90% of its direct earned premium in homeowner's insurance or (2) writes 90% of its direct earned premium in California. The parties' note that Mercury writes only 30.8% of its direct earned premium in homeowner's insurance and writes only 87.3% of its direct earned premium in California.

2. Mix of Business

Consumer Watchdog's analysis of Mercury's mix of business reaches markedly different conclusions. Consumer Watchdog contends the catastrophic risk in California is less than the average for homeowner's insurance nationwide. Mr. Schwartz also argues that given the size and geographical differences within the State, an insurer writing most of its business in California could still be considered to have a diversified risk.[355] In support of this assertion, Mr. Schwartz notes that California is geographically larger than the 10 Northeast states combined, and hence has a wider degree of diversification than those 10 neighboring states.[356]

E. Analysis and Conclusions re: Leverage Factor Variance

Having considered the facts and arguments presented, the ALJ concludes Mercury does not qualify for the leverage factor variance.

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[354] CDI's Post-Hearing Opening Brief, 32:11-13; Consumer Watchdog's Post-Hearing Opening Brief, 26:3-20.

[355] Tr. 1440-1441:25-7.

[356] Tr. 1441:16-23.

1. Mercury Does Not Write 90% of its Direct Earned Premium in One Line

Mercury fails to meet the first qualifying criteria of the variance, which requires an insurer to write at least 90% of its direct earned premium in one line. Mercury writes 30.80% of its direct earned premium in its homeowner's line. That means Mercury's direct earned premium in all other lines equals 69.20%. While Mercury contends it writes 90% of its homeowner's business in California, that fact is not relevant. Mercury does not qualify for the variance unless it writes 90% of its *entire* direct earned premium in homeowner's insurance. Mercury's interpretation of the leverage variance is simply misguided and contrary to the plain language of section 2644.27, subdivision (f)(3).

Given the above discussion, the ALJ concludes Mercury fails to meet the first qualifying criteria of the variance.

2. Mercury Does Not Write 90% of its Direct Earned Premium in California

Mercury also fails to meet the second qualifying criteria of the leverage variance. Mercury writes 87.28% of its direct earned premium in California. This is nearly three percentage points short of the required 90%.

3. Mercury's Mix of Business Does Not Present Unique Risks

Having failed to prove that it either writes at least 90% of its direct earned premium in one line or at least 90% of its direct earned premium in California, Mercury likewise fails to show its mix of business presents investments risks different from the line as a whole. Even though Mercury may write a majority of its homeowner's business in California, there is no evidence that Mercury's concentration in California results in an investment risk different from the line as a whole. If, as Dr. Appel suggests, diversification alone were sufficient to demonstrate a different investment risk, the variance's second clause would be superfluous.

Accordingly, the ALJ concludes Mercury does not qualify for the leverage variance and the applicable leverage factor shall be 1.27.

III. Variance (f)(9) – Constitutional Variance

The Fifth Amendment to the United States Constitution provides that private property shall not be taken for public use without just compensation. The Fifth Amendment's "takings" clause has been interpreted to limit the power of the states to regulate, control or fix prices that producers charge to consumers for goods and services.[357] This protection extends to price-control regulations, such as the ratemaking formula herein.[358]

It was with this constitutional mandate in mind that the Commissioner implemented California Code of Regulation, title 10, section 2644.27, subdivision (f)(9), which provides the following as a valid basis for requesting a variance:

> That the maximum permitted earned premium would be confiscatory as applied. This is the constitutionally mandated variance articulated in *20th Century v. Garamendi* (1994) 8 Cal.4th 216, which is an end result test applied to the enterprise as a whole.

In order to understand and apply *20th Century's* confiscation standard, it is helpful to consider the case law relied upon therein.

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[357] *20th Century Ins. Co v. Garamendi, supra*, 8 Cal.4th at p. 292.
[358] *Federal Power Comm'n v. Hope Natural Gas Co.* (1944) 320 U.S. 591, 601.

A. Applicable Law

1. *Hope Natural Gas Co.*

As noted above, the "takings clause" of the Fifth Amendment limits the power of the states to regulate, control or fix prices that produces charge to consumers for goods or services. In interpreting the validity of price-fixing formulas, no case is more important than the U.S. Supreme Court's decision in *Federal Power Comm'n v. Hope Natural Gas Co.*, (1944) 320 U.S. 591 (*Hope*). In *Hope*, Hope Natural Gas challenged the validity of a rate reduction order issued by the Federal Power Commission under the Natural Gas Act of 1938. The Natural Gas Act provided that gas rates must be "just and reasonable" but did not provide any guidelines for interpreting that provision. The *Hope* court made clear that a "just and reasonable" rate must balance both investor and consumer interests.[359] If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry is at an end.[360] Thus, rates which enable an insurer to maintain its financial integrity, to attract capital and to compensate the investors for the risks assumed cannot be condemned as confiscatory even though they might produce only meager investment return.[361]

Hope Natural Gas was a wholly owned subsidiary of Standard Oil Company. During its decades of operations, Hope Natural Gas paid dividends of more than $97 million and accumulated an earned surplus of nearly $8 million.[362] In addition, in 1942, during half of which the lower rates were in effect, Hope increased its earned surplus and paid dividends of 7.5%. In fact, the Commission's rate order fixed a rate of return which

[359] *Hope Natural Gas, supra*, 320 U.S. at p. 603.
[360] *Id.* at p. 602.
[361] *Id.* at p. 605.
[362] *Id.* at p. 604.

permitted Hope to earn $2.1 million annually. In view of these considerations, the *Hope* court found an annual return of $2 million is "just and reasonable" and did not constitute an unlawful taking.[363]

2. *Jersey Central Power & Light*

Forty years later, the federal courts further clarified the "just and reasonable" end result test of *Hope*. In *Jersey Central Power & Light Co. v. FERC* (1987) 810 F.2d 1168, Jersey Central Power and Light challenged a rate reduction ordered by the Federal Energy Regulatory Commission as unconstitutional. Jersey Central noted that it had paid no dividends for the last four years and faced a prolonged inability to pay dividends if the rate reduction took place.[364] Further, its equity investors not only earned a zero return but were forced to pay the interest costs on Jersey Central's debt.

In ordering the FERC to conduct a hearing on Jersey Central's allegations, the Court held that while a regulated utility has no constitutional right to a profit, it must be permitted to demonstrate the impact of rate order on its investors.

> But absent the sort of deep financial hardship described in *Hope*, there is no taking, and hence no obligation to compensate, just because a prudent investment failed and produced no return. And even where the sort of deep financial hardship described in *Hope* is present, the utility is entitled only to an "end result" hearing, and 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 rate would not exploit consumers.[365]

The California Supreme Court subsequently reviewed the confiscation issue following the passage of Proposition 103, and further clarified the meaning of "deep financial hardship."

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[363] *Id.* at p. 605.
[364] *Jersey Central Power & Light Co. v. FERC* (1987) 810 F.2d 1168, 1178.
[365] *Id.* at p. 1183, fn. 3.

3. *20th Century v. Garamendi*

In 1989, various insurers challenged the validity of the Commissioner's rate rollback regulations promulgated as a result of Proposition 103. The insurers alleged the regulations lacked statutory support, set forth an invalid rate formula and constituted an unlawful taking under the due process clause of the Constitution. In addition, 20th Century Insurance argued that by setting its maximum earthquake rate for the rollback year at 98.89 percent of the 1987 rate, the Commissioner implemented a confiscatory rate.

After reviewing and considering the decisions in *Hope* and *Jersey Central*, the California Supreme Court ruled that an insurer can threaten confiscation only when it demonstrates the maximum permitted rate prevents it from operating successfully during the period of the rate.[366] In such circumstances, the insurer is characterized as experiencing "deep financial hardship" as a result of the total effect of the rate. Confiscation does not arise whenever a rate does not produce a profit which an investor could reasonably expect to earn in other businesses with comparable investment risks and which is sufficient to attract capital.[367] In addition, the Commissioner must not confine his inquiries either to the computation of costs of service or to conjectures about the prospective responses of the capital market.[368]

The *20th Century* Court also made it clear that the inability to operate successfully is a necessary, but not a sufficient, condition of confiscation.[369] The resulting rate must not be viewed in isolation as an end result. Instead, deep financial hardship must befall

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[366] *20th Century v. Garamendi, supra,* 8 Cal.4th at p. 296.
[367] *Id.* at pp. 297, 299.
[368] *Id.* at p. 320.
[369] *Id.* at pp. 296, 299.

the enterprise as a whole. Confiscation cannot be effected within one discrete line of insurance.[370]

Having made such rulings, the Court concluded 20th Century failed to demonstrate deep financial hardship to the enterprise as a whole. While the rate rollback appeared harsh when it is viewed in isolation, the Court noted that 20th Century was a multi-line insurer whose earthquake line accounted for only 1.35% of its overall business.[371] As such, the rollback's impact diminished significantly. The Court also noted 20th Century suffered very low earthquake losses and thus enjoyed a high profit in past years. Further, the final rollback amounted to only 12.2% of 20th Century's $8.7 million earned premium, or $1.06 million.[372] Given all these circumstances, the Court found the rate rollback did not result in confiscation to 20th Century.

While *20th Century* dealt with a rate rollback, the Commissioner specifically incorporated the holdings in *20th Century* in the language of Variance 9. Thus, in determining whether an insurer qualifies for relief under Variance 9, the ALJ must determine whether the insurer has made a prima facie showing that the maximum indicated rate produced by the regulatory formula results in deep financial hardship to the insurer's enterprise as a whole (rather than to a single line of insurance) such that the insurer cannot operate successfully during the rate period.

B. Findings of Fact

The ALJ finds by a preponderance of evidence the following facts regarding the rate formula, Mercury's historical underwriting profits, its investor pool and the impact of a rate decrease on Mercury Casualty.

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[370] *Id.* at pp. 308-309, 322.
[371] *Id.* at pp. 322-323.
[372] *Id.* at p. 323.

1. Rate Formula's Return on Surplus and Costs

Regulation 2644.16 provides for a maximum permitted after-tax rate of return. The maximum rate of return is calculated by adding the risk-free rate investment income rate to the statutory 6% rate of return. The Commissioner fixes the risk-free rate on a monthly basis by examining the investment returns on specific classes of assets. For September 30, 2011, the Commissioner set a risk-free rate of 1.33%.[373] Accordingly, the Commissioner's formula automatically generates for Mercury a 7.33% return on surplus.[374]

2. Mercury's Past Underwriting Profits

Mercury's financial data demonstrates Mercury's historical profitability on all lines both on a countrywide and California-specific basis. As seen in the chart below, Mercury's five year average net income as a percent of surplus equals 11.7%, while its 2009 and 2010 returns on surplus exceed the Commissioner's maximum rate of return for each of those periods.[375]

MCC Countrywide Historical Profits – All Lines (in millions)

Year	Net Income (After Tax)	Earned Premium	Beginning Surplus	Net Income % of Premium	Net Income % of Surplus
2006	$216.9	$1,262.4	$1,242.4	17.2%	17.5%
2007	$210.4	$1,166.2	$1,284.3	18.0%	16.4%
2008	$18.8	$1,061.2	$1,391.6	1.8%	1.4%
2009	$89.8	$992.4	$1,049.6	9.0%	8.6%
2010	$180.1	$1,007.6	$1,176.7	17.9%	15.3%
Total	$716.0	$5,489.7	$6,144.5	13.0%	11.7%

[373] The parties agreed to use the Commissioner's factors in place as of September 30, 2011, which coincides with the end of the data set provided by Mercury. (Exh. 48-5; Exh. 336; Exh. 525-1.) Use of current regulatory factors in only one aspect of the formula, rather than those in place on September 30, 2011, is not actuarially sound. This concept is more fully discussed in Section 5 above with respect to the adjustment of Mercury's FFE load.

[374] 6.00 + 1.33 = 7.33.

[375] Exh. 522-2; Exh. 522-3.

While Mercury's net income as a percentage of surplus varied during this period from 1.4% to 17.5%, Mercury maintained an A+ financial strength rating from AM Best, a leading credit rating organization dedicated to serving the insurance industry.[376] In addition, in 2010 Mercury reported after-tax net income of $180 million on all its lines.

Similar results are found when reviewing Mercury's profits from its California homeowner's line. In 2010, Mercury's calculated surplus from its homeowner's line alone totaled more than $159 million dollars, with a before tax profit of $57.5 million.[377] Likewise, Mercury's California book of business has steadily increased. In fact, Mercury's California homeowner's earned premiums have increased every year since 2004.[378]

Mercury's dividend payments to shareholders also demonstrate the company's financial stability. During the last five years, stockholder dividends exceeded $920 million, with dividends issued every year.[379] In 2010, Mercury paid its largest one-year dividend of $385 million.

3. Mercury's Investment Pool

Mercury General Corporation is a publicly-traded corporation on the New York Stock Exchange. Because Mercury Casualty is a wholly-owned subsidiary of Mercury General, potential shareholders may only invest in Mercury General. Shares of Mercury Casualty are not available.

Mercury General's founder and Chair of its Board of Directors, George Joseph, owns 34% of the outstanding shares of Mercury General. Mr. Joseph's wife, Gloria

[376] Exh. 435.
[377] Exh. 1-10.
[378] Exh. 95-1.
[379] Exh. 522-3.

Joseph, owns 17% of Mercury General.[380] All total, the Josephs own 51% of Mercury General.

4. Impact of Rate Decrease on Mercury's Financial Condition

The potential impact of each party's indicated rate on Mercury's future profitability is undisputed arithmetically.

a. Mercury's Projected Outcome

Mercury concedes its projection does not comply with the regulatory formula. For example, Mercury did not remove the December 2010 catastrophe losses from its projected losses. In addition, Mercury substituted its own expense and return data in place of the Commissioner's expense, reserve and investment return projections.[381]

Dr. Appel first calculated the premiums produced by the rate decreases. Using Mercury's projected losses, he then calculated Mercury's future expenses and expected investment income based on his own analysis of outside financial data.[382] According to Dr. Appel, if the Commissioner implements the CDI's rate decrease of 2.21%, Mercury's after tax operating profit equals approximately $3.7 million; if Consumer Watchdog's 8.39% rate decrease is enacted, Mercury's after tax profit would be negative $2.7 million.[383]

b. Consumer Watchdog's Projected Outcome

Consumer Watchdog analyzed Mercury's projected outcome using the Commissioner's value for underwriting expenses, ancillary income, income tax and investment returns as of September 30, 2011, as well as a projected loss amount that

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[380] Exh. 435-11.
[381] Appel PADT, 13:1-21.
[382] *Id.* at 14:10-15:8.
[383] *Id.* at 16:22.

excluded the December 2010 catastrophe losses.[384] Applying these values to each party's rate request results in the following table, as agreed upon by the parties:

<u>Comparison of Projected Underwriting Profit in California Homeowner's Line</u>
<u>(Amounts in 000's)</u>

Rate Component	CWD	CDI	MCC
Indicated Premium	$178,977	$191,002	$209,506
Losses	$100,778	$100,778	$100,778
DCCE	$11,818	$11,818	$11,818
Underwriting Expenses & AOE	$64,700	$69,047	$75,737
Underwriting Profit	$1,681	$9,359	$21,175
Ancillary Income	$1,152	$1,152	$1,152
Underwriting & Other Income-Before Tax	$2,833	$10,511	$22,327
Tax on Underwriting & Other Income	$992	$3,679	$7,814
Underwriting & Other Income-After Tax	**$1,842**	**$6,832**	**$14,512**

Based on the above chart, Mercury's rate request results in a before tax annual profit of $22.3 million and an after tax annual profit of $14.5 million. Applying the CDI's proposed rate, Mercury's before tax annual profit equals $10.5 million and an after tax annual profit of $6.8 million. Under the Consumer Watchdog's proposed rate decrease, Mercury would earn a before tax profit of $2.8 million and an after tax profit of $1.8 million.[385]

Consumer Watchdog also considered the investment income on reserves and surplus. After factoring in those values, Mercury's projected rate of return is as follows:[386]

Rate Component	CWD	CDI	MCC
After-Tax Rate of Return on Surplus	7.37%	10.27%	14.09%

[384] As noted above, the parties agreed to apply those factors in place as of September 30, 2011.
[385] Schwartz PADT, 8:2-20.
[386] *Id.* at 10:21.

C. Parties' Contentions

Mercury presents a variety of arguments in favor of its qualification for the confiscation variance. Initially, Mercury attempts to relitigate the regulatory formula by arguing for an alternate meaning of confiscation.[387] In essence, Mercury argues that unless it is permitted to earn a "fair rate of return" the formula results in confiscation. Alternatively, Mercury also argues that in order to demonstrate deep financial hardship, it must be permitted to substitute its own cost and expense calculations. Under this "out of pocket" test, any rate that does not allow an insurer to covers its own costs is confiscatory, regardless of whether the insurer's costs match those provided for in the regulatory formula. In another challenge to the plain meaning of the Regulations, Mercury argues the phase "enterprise as a whole," as used in Variance 9, relates to the single line of insurance at issue in the proceeding.[388] Finally, Mercury attacks the testimony of the CDI's and Consumer Watchdog's witnesses.[389]

The CDI and Consumer Watchdog argue Mercury does not qualify for the confiscation variance because Mercury failed to provide any evidence to demonstrate the rate decrease would result in deep financial hardship to Mercury Casualty as a whole.

D. Analysis re: Confiscation Variance

Having considered the evidence presented and the parties' legal arguments, the ALJ concludes Mercury failed to demonstrate the rate decrease results in deep financial hardship. The ALJ also concludes "enterprise as a whole" depends on the condition of the Mercury Casualty as a whole and not on the fortunes of any one or more of its lines.

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[387] Mercury's Post-Hearing Opening Brief, 80:18-23.
[388] Mercury's Post-Hearing Reply Brief, 35:15-38:7.
[389] Mercury's Post-Hearing Opening Brief, 97:17-109:22.

1. Mercury Fails to Demonstrate the Maximum Indicated Rate Results in Deep Financial Hardship

Applying the clear holding of *20th Century*, Mercury must make a prima facie showing that the regulatory formula's maximum permitted indicated rate results in deep financial hardship. Absent such a showing, the Commissioner's inquiry ends. Because the maximum indicated rate permits Mercury to earn a profit and maintain its financial integrity, the ALJ concludes maximum indicated rate is not confiscatory.

a. Maximum Indicated Rate Results in Profit to Mercury

The Commissioner's formula results in at least $1.8 million profit from Mercury's California homeowner's line. Mercury fails to demonstrate the total effect of such a profit is unjust. Mercury is a multi-line insurer with policyholders in a number of states, including California. Mercury's California homeowner's line accounts for less than 30% of Mercury's overall 2010 earned premium. Applying a rate decrease of 8.18% to Mercury's HO-3 policy form and rate increases to policy forms HO-4 and HO-6, results in at least a 7.37% after-tax rate of return and at least $1.8 million profit to Mercury.

Mercury makes a number of assumptions regarding the impact of a $1.8 million profit, but provides no definitive facts supporting these assumptions. Without such facts, Mercury's arguments amount to little more than conjecture and certainly do not carry the burden of showing the rate to be unjust.

b. Maximum Rate Maintains Mercury's Financial Integrity

While perhaps not generating the profit margin Mercury desires, Mercury failed to demonstrate the rate decrease will impair the company's financial integrity. In fact, examinations of Mercury's credit rating and past rate applications show quite the opposite.

From 2006 through 2010, Mercury maintained an A+ financial strength rating from AM Best. During this same period, Mercury's return on surplus fluctuated from 1.4% to 17.5%. Yet at no time did Mercury's financial strength rating drop below the zenith mark of A+. In fact, Mercury's 2010 California operations show a robust policyholder surplus of $975 million. In addition, Mercury has not exhibited any signs of financial distress. Mercury did not present evidence that its stock prices or credit ratings have slipped, nor did Mercury demonstrate a contraction in its homeowner's business. Indeed, Mercury's California homeowner's earned premiums have increased every year since 2004.[390]

Similarly, Mercury failed to demonstrate past rate applications have weakened Mercury's financial integrity. While confiscation is determined prospectively, the Commissioner may draw some limited inferences from past applications of the rate formula. For example, under the Commissioner's regulatory formula, Mercury has realized profits in the millions of dollars every year. In addition, over the last 5 years Mercury has issued dividends totaling nearly $1 billion.

c. No Evidence Demonstrating Investor Flight

Mercury also offers testimony that investors will flee from Mercury if its homeowner's line earns only a meager profit. But Mercury fails to provide any support for this argument. Mercury did not provide evidence that its competitors have seen investors flee in similar circumstances, nor did Mercury demonstrate its investors fled in 2008 when the company made only a 1.4 percent return on surplus. In addition, there is

[390] Exh. 95-1.

no evidence that stock dividends would be negatively influenced by a small profit in one line. This is especially true given that in 2008 Mercury issued stockholder dividends totaling $140 million.

Further, Mercury's argument regarding investor flight seems self-serving. Mercury argues investors expect significant returns on their stock purchases and will withdraw their capital if Mercury's homeowner's line earns a small profit. Yet, a majority of this company is held by insiders, and not the general public. As noted above, the Joseph's own more than 51 percent of Mercury General and it seems unlikely the Joseph's would remove their capital from the company.

d. Pursuant to the Relitigation Ban, the Regulatory Formula Does Not Permit Use of Alternate Cost & Expense Calculations

Mercury argues any analysis of confiscation must permit an insurer to apply cost and expense amounts different from those provided by the regulatory formula. It is those costs that Mercury seeks to apply when discussing deep financial hardship. In support of this argument, Mercury contends the regulatory formula's after-tax rate of return is insufficient. This argument amounts to little more than impermissible relitigation of the regulatory formula, and must again be rejected.[391]

The Regulation makes clear an insurer must make a prima facie showing that the maximum indicated rate would be confiscatory as applied, in order to be eligible for Variance 9. As such, Mercury must demonstrate it will suffer deep financial hardship if the regulatory formula's maximum indicated rate is applied to its enterprise. Rather than providing evidence regarding the application of the regulatory formula, Mercury argues

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[391] *20th Century v. Garamendi, supra*, 8 Cal.4th at p. 312; *In the Matter of the Rate Application of American Healthcare Indemnity Company*, PA-2002-25379, at p. 9.

for its own cost and expense calculations. But costs and expenses calculated by the regulatory formula are the proper figures to consider when demonstrating deep financial hardship.

In addition, a just and reasonable return does not require that a company's costs be determined and then rates fixed to cover those costs.[392] An agency may use average costs and fix rates based on such costs, just as the Commissioner's formula has done. Mercury argues such an examination is redundant because the regulatory formula will always generate the rate of return guaranteed by the Commissioner; a rate Mercury finds insufficient. As noted above, the regulatory formula guarantees Mercury a just and reasonable after-tax rate of return of 7.33%. The regulatory formula does not impose a rate that inflicts on insurers the sort of deep financial hardship described in *Hope*.[393] While Mercury may wish for a greater rate of return under the formula, it is not entitled to more than what is provided for in the Regulation, absent a showing of deep financial hardship. This is a well-settled issue and Mercury's argument is yet another attempt to relitigate the Commissioner's formula.

2. Mercury Fails to Demonstrate Harm to its Enterprise as a Whole

Even if Mercury received reduced or negligible profits in its California homeowner's line, Mercury still fails to show deep financial hardship to Mercury Casualty as a whole. Although Mercury argues "enterprise as a whole" must mean each individual line of insurance, such an argument is contrary to clear case law and based on defective logic.

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[392] *20th Century v. Garamendi, supra*, 8 Cal.4th at p. 293; *Giles Lowery Stockyards v. Dept. of Agriculture* (5th Cir. 1977) 565 F.2d 321, 327.
[393] *20th Century v. Garamendi, supra*, 8 Cal.4th at p. 297.

As noted above, in *20th Century* the California Supreme Court stated no less than three times, that confiscation depends on the condition of the insurer as a whole, and not on the fortunes of any one or more of its lines.[394] In so holding, the Supreme Court stated the earned premium of 20th Century's earthquake line must not be viewed in isolation as an end result, but instead as an intermediate step in evaluating the corporation's overall financial fitness.[395]

Mercury counters that *20th Century*'s enterprise as a whole discussion applies only to rate rollback cases. This argument ignores the fact that the Commissioner specifically adopted *20th Century*'s enterprise as a whole test in the prior approval regulations, effectively ending this argument.

3. Confiscation is Not Judged Under a "Fair Rate of Return" Standard

Ignoring the relitigation ban and the ALJ's clear Orders throughout this proceeding, Mercury again argues the proper test for confiscation is a "fair rate of return" test, and not the "deep financial hardship" test provided for in *20th Century*. In support of this argument, Mercury cites passages from *20th Century* as well as holdings in several rent control cases. But, Mercury misrepresents the decision in *20th Century* and relies on superseded and unrelated case law.

a. *20th Century* Never Uses "Fair Rate of Return"

Mercury states that *20th Century* provides for a fair rate of return test and cites numerous passages in support of this contention. For example, Mercury claims:

> *20th Century* confirmed that the constitutional variance tests to see if the rates resulting from the application of the

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[394] *20th Century v. Garamendi, supra,* 8 Cal.4th at pp. 293, 308-309, 322.
[395] *Id.* at p. 322.

> regulatory formula would deny an insurer the opportunity to earn a just, reasonable and fair return.[396]

Mercury also asserts *20th Century* stands for the proposition that "there be enough revenue not only for operating expenses but also for the capital costs of the business."[397] Despite Mercury's assertions, *20th Century* never uses the phrase "fair rate of return," nor does the decision endorse such a revenue test.

Rather, the Supreme Court discussed "fair rate of return" in *Calfarm Ins. Co. v. Deukmejian* (1989) 48 Cal.3d 805; a decision that was modified by *20th Century*. While *Calfarm* required rates which can be described as "fair and reasonable,"[398] the same Supreme Court later abandoned the notion of a "fair rate of return" in favor of a "just and reasonable" standard. As the Supreme Court stated in *20th Century*, "the crucial question under the takings clause is whether the rate set is just and reasonable."[399] If it is not just and reasonable, it is confiscatory. It is the decision in *20th Century* that is specifically referenced in Regulation 2644.27, subdivision (f)(9), and it is that holding the ALJ must apply.

Contrary to Mercury's assertions, the holding in *20th Century* does not state that there must be "enough revenue not only for operating expenses but also for the capital costs of the business." In an attempt to support its revenue theory, Mercury's brief cobbles together language from two vastly different sections of the *20th Century* decision and then adds language that does not appear in the decision.[400] But, the Court in *20th*

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[396] Mercury's Post-Hearing Reply Brief, 19:3-5.
[397] *Id.* at 19:20-25.
[398] *Calfarm Ins. Co. v. Deukmejian, supra*, 48 Cal.3d at 822-823.
[399] *20th Century v. Garamendi, supra*, 8 Cal.4th at p. 292.
[400] Mercury's Opening and Reply Briefs repeatedly misquote the holdings in *20th Century* and string together language from various sections of the decision in what can only be interpreted as a desperate attempt to support its fair rate of return test.

Century clearly states that enough revenue for operating expenses and cost of capital is an interest, not a right.

> 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 business. . .
>
> It must be emphasized that the foregoing describes an interest that the producer may pursue and not a right that it can demand.[401]

b. Mercury Relies On Unrelated Case Law To Support its Fair Rate of Return Test

Mercury also relies on unrelated post-*20th Century* decisions to support its fair rate of return test.[402] These cases are distinguishable from *20th Century* as they do not rely on *20th Century*'s interpretation of confiscation but on case law dealing with government restrictions on the use of private property.

Mercury cites *Kavanau v. Santa Monica Rent Control Board* (1997) 16 Cal.4th 761, and its progeny, for the concept that an insurer must be able to earn a fair rate of return. But such reliance is misplaced. First, these cases pertain not to insurance regulations but to rent control ordinances. Rent control ordinances evolved from eminent domain cases where the government has placed conditions on the exercise and use of private property; not from Proposition 103.[403] In addition, rent control ordinances generally provide for automatic rate increases and do not involve the same economic factors used in insurance rate regulation.

Second, the California Supreme Court applies an entirely different "takings" test in rent control cases. Unlike the holding in *20th Century*, the due process standard in rent

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[401] *Id.* at p. 294.
[402] Mercury's Post-Hearing Opening Brief, 85:16-86:22; Mercury's Post-Hearing Reply Brief, 20:1-21:13.
[403] Meltz, *Takings Law Today: A Primer for the Perplexed* (2007) 34 Ecology L.Q. 307.

control cases measures for a fair rate of return. The Supreme Court notes the different confiscation standard and cites its holding in *Fisher v. City of Berkeley* (1984) 37 Cal.3d 644 in support of the fair rate of return test. At no point does the *Kavanau* Supreme Court indicate the fair rate of return test is a result of its holding in *20th Century*. Most notably, while the *20th Century* Court was presumably aware of the fair return test for rent control cases, it failed to mention *Fisher* or other rent control cases when setting the parameters of the "deep financial hardship" test under the Commissioner's regulations.

Based on the foregoing, Mercury has failed to meet its burden of proof on the confiscation issue and its legal arguments in furtherance of its position on confiscation are without merit. Accordingly, the ALJ concludes Mercury does not qualify for Variance 9.

Conclusions of Law

1. All findings in this decision shall be considered to be either findings of fact or conclusions of law. They should be read in conjunction with the discussion above which explains the reasons for the determinations.

2. The hearing was full and fair and allowed the parties a reasonable opportunity to conduct discovery, present testimony and documentary evidence, cross examine witnesses and submit pre-hearing and post-hearing briefs on the disputed issues in this matter.

3. In a rate hearing, the Commissioner reviews the Applicant's proposed rates and determines whether they are excessive, inadequate or unfairly discriminatory using the methodology set forth in California Code of Regulations, title 10, section 2642.1, et seq.

4. The amended version of the ratemaking regulations contained in California Code of Regulations, title 10, section 2642.1, et seq., effective May 16, 2008, applied in this proceeding.

5. Mercury bears the burden of proving by a preponderance of the evidence that the requested increase will not result in excessive, inadequate or unfairly discriminatory rates as defined in California Code of Regulations, title 10, section 2644.1, et seq.

6. From December 17 through December 25, 2010, Mercury experienced catastrophic losses which must be removed from the amount of projected losses.

7. Mercury shall remove no less than $7,529,928 in catastrophic losses from its policy form HO-3 projected losses as a result of the December 2010 catastrophic rain event.

8. Mercury's average catastrophe factor for policy form HO-3 is 1.062.

9. Mercury demonstrated RiskLink 9.0 conforms to actuarial standards of practice and is based upon the best scientific information available.

10. Mercury failed to support its trending of the FFE losses.

11. Mercury's selection of a 4.2% FFE ratio is actuarially sound.

12. Mercury shall apply a selected catastrophe factor of 1.100 to its HO-3 policy form.

13. Mercury's loss development and DCCE development factors are as follows: 1.109 for policy form HO-3; 1.170 for policy form HO-4; and 1.084 for policy form HO-6.

14. The most actuarially sound loss trend for Mercury's policy form HO-3 is the 16 point trend, which results in -0.4% trend.

15. The most actuarially sound loss trend for Mercury's policy form HO-4 is the 16 point trend, which results in 5.2% trend.

16. The most actuarially sound loss trend for Mercury's policy form HO-6 is the 16 point trend, which results in 9.3% trend.

17. Mercury's DCCE for policy form HO-3 equals $9,847,141.

18. Mercury's political expenditures of $183,326 for 2008, $210,656 for 2009 and $528,015 for 2010 shall be included in the calculation of Mercury's excluded expense factor.

19. All of Mercury's advertising expenses constitute "institutional advertising" and shall be included in the calculation of Mercury's excluded expense factor.

20. Mercury's three year average excluded expense factor equals 1.30%.

21. Mercury's efficiency standard equals 35.82%.

22. The regulatory ratemaking formula, without a variance, indicates a rate decrease of 8.18% for Mercury's HO-3 line.

23. The regulatory ratemaking formula, without a variance, indicates a rate increase of 4.32% for Mercury's HO-4 line.

24. The regulatory ratemaking formula, without a variance, indicates a rate increase of 29.44% for Mercury's HO-6 line.

25. Mercury failed to support its request for a variance under California Code of Regulations, title 10, section 2644.27, subdivision (f)(3). Mercury did not satisfy its burden of proof that it writes at least 90% of its direct earned premium in one line or that it writes at least 90% of its direct earned premium in California. In addition, Mercury did

not satisfy its burden of proof that its mix of business presents investment risks different from the risks typical of the line as a whole.

26. Mercury failed to support its request for a variance under California Code of Regulations, title 10, section 2644.27, subdivision (f)(9). Mercury did not satisfy its burden of proof that application of the maximum permitted earned premium results in deep financial hardship to Mercury Casualty as a whole.

Order

Based on the foregoing, IT IS ORDERED that:

1. Mercury's requested rate increase of 8.8% is denied.

2. An 8.18% rate decrease is approved for policy form HO-3 and shall become effective 20 days after the adoption of this decision by the Commissioner or as soon thereafter as Mercury is able to provide the necessary documentation to and implement the necessary changes with the California Department of Insurance Rate Filing Bureau.

3. A 4.32% rate increase is approved for policy form HO-4 and shall become effective 20 days after the adoption of this decision by the Commissioner or as soon thereafter as Mercury is able to provide the necessary documentation to and implement the necessary changes with the California Department of Insurance Rate Filing Bureau.

4. A 29.44% rate increase is approved for policy form HO-6 and shall become effective 20 days after the adoption of this decision by the Commissioner or as soon thereafter as Mercury is able to provide the necessary documentation to and implement the necessary changes with the California Department of Insurance Rate Filing Bureau.

This proposed decision on remand is submitted on the basis of the entire record in this proceeding and I recommend its adoption as the decision of the Insurance Commissioner of the State of California.

Dated: January 28, 2013

KRISTIN L. ROSI
Administrative Law Judge
Administrative Hearing Bureau
California Department of Insurance

DECLARATION OF SERVICE

Case Name/No.: In the Matter of the Rate Application of:
Mercury Casualty Company
File No. PA-2009-00009

I, NATALIE BRUTON-YENOVKIAN, declare that:

I am employed in the County of Sacramento, California. I am over the age of 18 years and not a party to this action. My business address is State of California, Department of Insurance, Executive Office, 300 Capitol Mall, Suite 1700, Sacramento, California, 95814.

I am readily familiar with the business practices of the Sacramento Office of the California Department of Insurance for collection and processing of correspondence for mailing with the United States Postal Service. Said ordinary business practice is that correspondence is deposited with the United States Postal Service that same day in Sacramento, California, unless indicated otherwise on the service list.

☒ On February 11, 2013, following ordinary business practices, I caused a true and correct copy of the following document(s):

ORDER ADOPTING PROPOSED DECISION: AND PROPOSED DECISION

unless otherwise indicated on the service list to be placed for collection and mailing at the office of the California Department of Insurance at 300 Capitol Mall, Sacramento, California, 95814 with proper postage prepaid, in a sealed envelope(s) addressed as follows:

(SEE ATTACHED SERVICE LIST)

I declare under penalty of perjury that the foregoing is true and correct, and that this declaration was executed at Sacramento, California, on FEBRUARY 11, 2013.

Natalie Bruton-Yen

NATALIE BRUTON-YENOVKIAN

SERVICE LIST
FILE NO. PA-2009-00009

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