A Fair Rate Of Return Is Required When States Set Prices

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If the government sets prices for an industry but sets the rates so low that some businesses are unable to operate successfully, have the businesses been "taken" in violation of the takings clause of the Fifth Amendment? That's the question that the U.S. Supreme Court is being asked to hear in the case of Mercury v. Jones, currently on petition to the Supreme Court. The court should grant Mercury's petition in order to clarify the constitutionally required fair rate of return standard.

In general, businesses don't have a constitutional right to earn a profit, but if the government steps in and starts setting prices, things are a little different. The state's intervention in the free market restricts a company's ability to determine prices in response to market considerations. As a result, it has long been held that the Constitution requires that the company can earn a fair rate of return, otherwise the company would essentially be "taken" by bankruptcy, violating the takings clause.

California is now putting the definition of "fair rate of return" to the test. Under its Proposition 103, California regulates the premiums insurers can charge their customers. Mercury Casualty Company filed an application with the California Insurance Commissioner to increase its homeowners' insurance rates. Mercury sought a variance from the regulatory maximum rate, contending that a lower rate would unconstitutionally deprive it of a fair rate of return. The commissioner denied the application because Mercury had not shown the variance was needed in order to prevent deep financial hardship.

The California Court of Appeal agreed with the commissioner's decision and ruled that "deep financial hardship" is the standard to be applied. In a stark break from precedent, the court held that firms subject to rate regulation have no constitutional right to earn a "fair rate of return."

Instead, the court stated that firms are entitled to relief only from rates that inflict the kind of "deep financial hardship" that leaves them unable "to operate successfully." This misunderstands the longstanding rule and could threaten the many rate-regulated companies in California, and possibly elsewhere, with financial ruin.

The Supreme Court made clear in Federal Power Commission v. Hope Natural Gas Co. that regulated entities are entitled to a fair rate of return. A "fair rate of return" was defined as a return sufficient to attract capital and commensurate with what investors reasonably could expect to earn in other businesses with comparable risks. The court emphasized that rates should "enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed." The company must also earn enough to allow for future development of the business. This means enough revenue to cover "not only … operating expenses, but also … the capital costs of the business … includ[ing] service on the debt and dividends on the stock."

For the California Court of Appeal, however, Hope Natural Gas's definition of a fair rate of return wasn't clear enough. The court not only ignored Supreme Court precedent, but also the Ninth Circuit, of which California is a part, which similarly evaluated a Nevada law that was virtually identical to California's Proposition 103. In Guaranty National Insurance Co. v. Gates, the Ninth Circuit found the Nevada law unconstitutional because it would require insolvency — essentially deep financial hardship — in order for a company to be entitled to a higher rate. The court stated that this would not "guarantee the constitutionally required 'fair and reasonable return'" mandated by the Supreme Court's decision in Hope Natural Gas. In fact, the court — referring to an earlier California Supreme Court decision, Calfarm Insurance Co. v. Deukmejian — mentioned that the only reason California's Proposition 103 was upheld as constitutional was because its "insolvency" provision could be severed from the rest of the statute. The California Supreme Court invalidated that provision because it "preclude[d] adjustments necessary to achieve the constitutional standard of fair and reasonable rates."

The Court of Appeal in Mercury instead relied on the California Supreme Court's decision in 20th Century Insurance Co. v Garamendi, but that reliance was misplaced. In 20th Century, the court held that the ratemaking formula in Proposition 103 was not unconstitutional because it was "designed to yield a nonconfiscatory rate." But Mercury sought a variance from the rate, a variance that 20th Century Insurance held is "available to the individual insurer on proof of confiscation." As it pertains to individual rates, a constitutionally mandated variance exists. Otherwise, a one-size-fits-all rule without exception could exact extreme financial hardship on

some companies due to the vagaries of the local economy. A variance allows companies to earn the constitutionally required fair rate of return, and it was that variance the California Court of Appeal incorrectly determined does not apply unless a company faces deep financial hardship.

The United States Supreme Court should review and reverse the California Court of Appeal's decision. The court should clarify the standard and put governments on notice that price controls have limits. While the state has an interest in allowing consumers stable access to a product, the firm has an interest in remaining financially solvent. And, of course, a firm that has gone out of business can't provide anything to anyone. By taking the case, the court can resolve the current split between four state supreme courts that agreed with California and the six state supreme courts and three federal courts of appeal that do not. The court can also prevent companies subject to rate regulation in the nation's largest economy from being subject to confiscatory rates, not to mention the national firms which will be impacted by the losses they will suffer in California.

When a business loses the freedom to operate according to free market principles, it must gain the right to a fair rate of return. The firm exchanges its right to charge whatever it wants according to market demand for the right to make a return which allows it to operate successfully. Going out of business is not a "fair rate of return."

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