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BEFORE THE INSURANCE COMMISSIONER
OF THE STATE OF CALIFORNIA

In the Matter of the Rate Application of, State Farm General Insurance Company, Applicant.	File No.: PA-2015-00004 **CONSUMER WATCHDOG'S POST-HEARING OPENING BRIEF**

PUBLIC- REDACTED VERSION

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I. INTRODUCTION AND SUMMARY OF ARGUMENT: STATE FARM'S REQUESTED RATE IS EXCESSIVE.

Insurance Code[1] section 1861.05 provides that "[n]o rate shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of this chapter." This case concerns both "approval" of a rate and an evaluation of State Farm's "in effect" rate.[2]

State Farm General Insurance Company ("State Farm" or "State Farm General") is seeking an overall increase of 6.4% to its homeowners insurance rates across all three forms (homeowners, condominium, and renters).[3] This rate is excessive. Instead, under a proper application of the ratemaking regulations and based on the record in this case, State Farm should be implementing an overall rate ***decrease*** of *at least* 9.26%.[4] This means that State Farm has been overcharging its homeowners policyholders over $8.5 million per month ($285,000 per day)[5] while this proceeding has been underway. This proper rate was calculated as of July 15, 2015, so at a minimum, State Farm has been overcharging all of its policyholders since then, and accordingly, refunds should be ordered at least going back to that date.

State Farm has attempted to justify its excessive current and proposed rates by taking aggressive, and untenable, positions on virtually every contested issue. The majority of State Farm's case rests on arguments that it should be allowed to invoke numerous exceptions to the Regulatory Formula[6] established pursuant to Proposition 103. State Farm:

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[1] Unless otherwise indicated, all statutory citations are to the Insurance Code and all citations to regulations are to Title 10 of the California Code of Regulations ("10 CCR").
[2] See Notice of Hearing, June 22, 2015, p. 3.
[3] See, e.g., Terry PDT, ¶ 22.
[4] See Schwartz Rebuttal, 3:12. As Mr. Schwartz stated, adopting the catastrophe values proposed by either the California Department of Insurance ("CDI") or Consumer Federation of California ("CFC") will result in an even lower rate. (Schwartz Rebuttal, fn. 3.)
[5] The maximum indicated rate of negative 9.26% equals an overcharge of State Farm's policyholders of $104 million annually ($1,123,432,230 [adjusted annual premium from template calculations] x 9.26% [maximum profit from templates] = $104,029,824.50), which is $8.6 million per month ($104,029,824.50 ÷ 12 = $8,669,152) and $285,013 per day ($104,029,824.50 ÷ 365 = $285,013).
[6] There are two formulas contained in the regulations, the "maximum permitted earned premium" and the "minimum permitted earned premium. (See 10 CCR §§ 2644.2, 26443.) Since the insurer is entitled to any rate within the range of rates calculated by the two regulatory formulas, the parties here are

- Refuses to accept that the rate must be calculated using the projected yield calculated in accordance with the applicable regulations. Instead of using the asset distribution contained in the "consolidated statutory annual statement"[7] to calculate the projected yield as required by the regulation,[8] State Farm seeks to use the asset distribution contained in State Farm General's individual ***un***consolidated annual statement.
- Claims that calculating the projected yield using the asset distribution in the State Farm Group's annual statement instead of its preferred asset distribution will deprive State Farm General of a fair rate of return, thus resulting in confiscation and triggering variance 9. However, State Farm's substitution of its own preferred methodology for that of the applicable rate regulations is prohibited by the regulation as relitigation.[9] And according to the case law, such a piecemeal attack on individual components of the Regulatory Formula[10] does not establish confiscation, which requires a balancing of the insurer's and consumers'

disputing the *maximum* allowed, i.e., the maximum permitted earned premium. As such, CWD will generally refer herein to these formulas with the singular "Regulatory Formula."

[7] The "consolidated" annual statement is now called the "combined" annual statement (see, e.g., Schwartz PDT, at 7:13-27; Hemphill PDT, at 5:20-26), and it refers to an annual statement containing combined data for all insurers in a particular ownership group (Exh. 13-001). In this proceeding, this refers to the combined annual statement of State Farm Mutual Automobile Insurance Company ("State Farm Mutual") and its affiliates (State Farm Mutual and its property and casualty affiliates are collectively referred to as the "State Farm Group"). The State Farm Group includes the applicant, State Farm General Insurance Company. (See Exh. 14-001.)

[8] 10 CCR § 2644.20 ["[u]sing the insurer's most recent consolidated statutory annual statement . . . "].

[9] 10 CCR § 2646.4(c).

[10] There are two formulas contained in the regulations, the "maximum permitted earned premium" and the "minimum permitted earned premium. (See 10 CCR §§ 2644.2, 2644.3. Since the insurer is entitled to any rate within the range of rates calculated by the two regulatory formulas, the parties here are disputing the *maximum* allowed, i.e., the maximum permitted earned premium. As such, CWD will generally refer herein to these formulas with the singular "Regulatory Formula."

interests and a showing that the rate calculated by the Commissioner will result in an "inability to operate successfully."[11,12]

- Seeks a leverage variance, even though State Farm has failed to prove that "its mix of business presents investment risks different from the risks that are typical of the line as a whole."[13] Among other things, State Farm has failed to meet its burden of proving that the investment risks associated with its mix of business are more risky than the homeowners line as a whole, whether that is measured against the California homeowners line, the countrywide line, or both. In fact, the evidence shows that in both markets, State Farm General and State Farm Group are *less risky* than the line as a whole. And even if State Farm were able to prove that it is more risky, which it has not and cannot, State Farm has not proven that any purported increased riskiness is due to its mix of business.
- Uses an improper catastrophe load. Among other things, State Farm (and its outside actuary) relies on inappropriate data for calculating/validating its selected cat load trend, uses an upward cat load trend when State Farm's California catastrophe data shows a downward trend, and fails to adjust for the Oakland Hills Fire, which is a 1-in-50 year event contained within a dataset that covers less than 50 years. And State Farm's own documents show that it believes its catastrophe ratio for the homeowners line [redacted]

[11] As explained below, even using State Farm's improper yield and catastrophe calculations, State Farm will show a $27 million annual profit under the proposed rate. Furthermore, in the last ten years – using rates calculated pursuant to the Regulatory Formula – State Farm General alone has averaged profits of $300 million *per year*. Finally, the State Farm Group has averaged $2.485 billion in profit annually for the last 10 years.

[12] As discussed below, State Farm's confiscation calculation – Exhibit 25 – uses a projected investment yield lower, and an investment tax rate higher, than it believes it will realize. Both of those items result in an understatement of profits relative to even what State Farm believes it is expected to earn. Hence, State Farm's confiscation calculation does not constitute an "as applied" analysis. For this, and other reasons, State Farm's "test" of confiscation – Exhibit 25 – has no probative value.

[13] As discussed later, State Farm, in an attempt to support its requested leverage variance, changed its story many times. The multiple versions and various inconsistencies in State Farm's leverage variance clearly demonstrate that State Farm has provided no reasonable or rational grounds for the requested leverage variance.

Under a proper application of the regulations and the statute, and on the basis of the record, State Farm should be ordered to decrease its overall rates by at least 9.26% and issue refunds to policyholders, who it has been overcharging by over $8.5 million per month since at least July 15, 2016.

II. BACKGROUND AND OVERVIEW OF REGULATORY FORMULA COMPONENTS IN DISPUTE

As the above summary makes clear, there are three components of the Regulatory Formula at issue in this proceeding: 1) the catastrophe adjustment, which is determined pursuant to 10 CCR § 2644.5; 2) the projected yield, which is calculated pursuant to 10 CCR § 2644.20[14]; and 3) whether or not to grant State Farm a variance to the insurer-promulgated leverage factor value (10 CCR § 2644.17), which determination is governed by 10 CCR § 2644.27(f)(3). Each of these components and related issues is explained briefly below and expanded upon in the discussion in sections IV and V, below.

A. Catastrophe Adjustment.

The catastrophe adjustment – also called the "catastrophe load" or "cat load" – is an amount added in to the rate to account for a multi-year, long-term average of catastrophe claims. (See, e.g., 10 CCR § 2644.5.) The cat load allows insurers to charge policyholders for the expected annual costs of catastrophes over a longer-term period, as opposed to including the actual catastrophe losses in its projected losses, which vary significantly between years and can be quite substantial in any given year. This is important for at least two reasons. First, it spreads the costs for policyholders in a more even, predictable manner, and second, it is more actuarially sound because under the ratemaking formula projected losses are based on shorter-term experience (e.g., one to three years[15]), which could be skewed in years with high catastrophe losses. In the homeowners line, it is common for insurers to calculate the catastrophe provision for the fire following earthquake ("FFE") peril separately from other perils.[16] In this proceeding, the parties have stipulated to a FFE value, so the parties' dispute concerns only the catastrophe adjustment excluding FFE.

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[14] This also State Farm's variance 9 request by which State Farm is seeking to use its preferred calculation for the projected yield instead of the calculation mandated by the regulation.
[15] See 10 CCR § 2642.6, "Recorded Period."
[16] This is allowed by the applicable regulation, 10 CCR § 2644.4(e).

In relation to the cat load, there are a number of items in dispute. Among the disputed issues are: 1) whether State Farm's California homeowners catastrophe experience is expected to trend upward, downward, or not at all; 2) what data set to utilize to conduct the trend calculation; 3) whether, and how, a trend line with an R-squared value[17] near 0 can be used, consistent with actuarially accepted practices, to calculate a trend; 4) whether to make an adjustment to the data used to calculate the long-term average for the Oakland Hills Fire; 5) which exposure base (e.g., amount of insurance years or "AIY" versus non-CAT losses) is most actuarially sound given the particular facts and circumstances for State Farm California homeowners insurance; 6) what number of years is most appropriate to calculate the long-term average; and 7) whether to do the calculations by form or use beta factors.[18]

As discussed in more detail in section IV.A., below, Consumer Watchdog only addresses the first four issues, concluding: 1) State Farm's California homeowners catastrophe experience is either flat or trending downward, but is definitely not trending upward; 2) the appropriate data set for determining a catastrophe trend is the California-specific homeowners insurance data used by State Farm to calculate the long-term catastrophe average; 3) a trend line with an R-squared near zero can, and in this case does, provide a reliable and actuarially sound trend value; and 4) since the long-term catastrophe average uses a dataset less than 50 years and the Oakland Hills Fire is a 1-in-50 year event, an adjustment must be made so the average is not overstated.

B. Projected Yield.

The projected yield is used to calculate the investment income that is reflected in the Regulatory Formula. (See, e.g., 10 CCR § 2644.19.) The purpose of the yield is to take into account the investment income the insurer is going to earn on surplus and reserves, which offsets the premium State Farm needs to charge to cover its losses and expenses and make a reasonable profit. (E.g., *ibid.*; see also Terry PDT, ¶¶ 11, 13, 14.) The yield used in the Regulatory Formula is calculated by multiplying the insurer's asset distribution by class of investment (e.g., short-term U.S. bonds or common stock) by the yields currently available on securities in US capital markets. (10 CCR § 2644.20(a).) The Commissioner has

[17] R-squared is a statistical measurement. As discussed later, R-squared is not necessarily a good statistical measure of how closely a trend line fits the actual data, or the reliability of the trend.
[18] This list is not meant to be exhaustive.

determined that the appropriate asset distribution for each insurer to use is the "consolidated statutory annual statement" (now "combined annual statement"),[19] which contains the combined data for a group of affiliated insurers.[20] Here, the appropriate annual statement is the combined annual statement of "State Farm Mutual Automobile Insurance Company *and its affiliated property and casualty insurers*," which includes State Farm General. (Exh. 14, p. 1, emphasis added.)

State Farm General makes two primary arguments in opposition to the yield regulation. First, State Farm argues that the general, introductory language of the regulation[21] controls, meaning that the *individual insurer's annual statement* – in this case State Farm General Insurance Company – must be used for the calculation. (See, e.g., State Farm General Insurance Company's Brief on the Merits of Non-evidentiary Objections ("State Farm Motion to Strike Brief"), Oct. 2, 2015, at 10:15 – 11:1.) Second, State Farm argues that it will *never* have the opportunity to earn a fair rate of return if it is required to follow the dictates of the projected yield regulation and that this constitutes confiscation. (See, e.g., State Farm Motion to Strike Brief, *supra*, at 18:16-18 ["the proposed interpretation and application to SFG of § 2644.20(a) would function to forever deprive SFG of rates allowing the opportunity to earn a fair rate of return."].) As State Farm argues, this is because State Farm General's assets are invested entirely in bonds and the State Farm Group has 42% of its assets invested in common stocks, which have a higher projected yield than bonds. (See, e.g., Exh. 701-2 [$64.5 billion in common stock (line 4) ÷ $152 billion total assets (line 10) = 42.43%].) Consumer Watchdog believes State Farm's argument is improper relitigation of a component of the Regulatory Formula, which is prohibited, and as such it cannot be the test for confiscation.

As explained below, the test for confiscation is *not* a test of a particular component of the Regulatory Formula, but instead measures the impact of the *end result* of the rate calculated under the Regulatory Formula on the insurer's "enterprise as a whole" and requires a showing of an "inability to

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[19] See, e.g., 2644.20(a) ["The weights shall be determined using the insurer's most recent consolidated statutory annual statement, and shall be computed by dividing the insurer's assets in each separate asset class shown on page 2, lines 1 through 9 of the insurer's consolidated statutory annual statement, by the total of lines 1 through 9."].

[20] Exh 13-001, ¶ 3.

[21] State Farm points to this sentence in 10 CCR § 2644.20(a): "'Projected yield' means the weighted average yield computed using the insurer's actual portfolio and yields currently available on securities in US capital markets."

operate successfully" under that rate. If State Farm General does not earn the investment return projected based upon the regulations, it is the result of actions by State Farm Mutual and State Farm General, not because of the actions of the State of California.

As to the yield issue, there is also a question of which time period for annual statement and yields to use in the calculation. While the CDI used the 2013 annual statement and yields as of September 2014, CWD and State Farm calculated the yield using the 2014 annual statement asset distribution and yields as of June 2015. As explained below in section IV.B, the CDI's expert agreed that either is appropriate, but a straightforward application of the regulations mandates use of the 2014 annual statement and June 2015 yields.

C. Leverage Factor.

The leverage factor is a commissioner-issued, industry-wide value calculated by line of insurance (e.g., homeowners, auto, etc.). (10 CCR § 2644.17(b).) The leverage factor is a ratio of premium to surplus, which imputes a fixed amount of surplus into the Regulatory Formula based on the insurer's actual premium.[22] In each line, the value before any variance is the same for all insurers.

The relationship between the leverage factor and the overall rate is inversely proportional. Lowering the leverage factor results in more surplus being imputed and leads to a higher overall rate. (See section V.A., *infra*.) By mandating a fixed value for all insurers, the leverage factor limits the premiums that can be charged by insurers with an actual surplus that is greater than the industry-wide average. Without the limitations of the leverage factor, insurers who chose to carry more capital than the Commissioner deems necessary (i.e., over-capitalized in the context of ratemaking) would be allowed to charge more.[23]

In this proceeding, State Farm seeks a leverage factor variance pursuant to 10 CCR § 2644.27(f)(3), which would increase the imputed surplus by approximately 17.6%, thereby increasing the overall rate. However, in order to qualify for the variance, an insurer must prove that: 1) it writes 90% of its direct earned premium either in one line or in California; and 2) its "mix of business presents

[22] 10 CCR § 2644.17(a).

[23] To be clear, the leverage factor works both ways, i.e., it also lowers the imputed surplus and *increases* the premiums under-capitalized insurers can charge.

investment risks different from the risks that are typical of the line as a whole." As explained below, State Farm has not met its burden.

The items in dispute are: 1) whether these prongs should be evaluated on a company-specific basis or a group-wide basis; and 2) whether State Farm's mix of business presents greater risks than the risks that are typical of the line as a whole. CWD believes the second, "mix of business" prong should be evaluated on a group-wide basis because insurer groups are generally able to coordinate and spread risk throughout the group, and State Farm Group specifically does coordinate and spread its risk throughout the group.

As to State Farm's risk, the evidence makes clear that both State Farm General, on its own, and State Farm Group, collectively, each have a mix of business that presents investment risks which are lower than the risks typical for the line as a whole.

III. ISSUES AND LEGAL STANDARDS

The Notice of Hearing provides that this hearing is to determine:

> (1) the maximum permitted rate of Applicant's homeowners coverages with an effective date of July 15, 2015 under Proposition 103 and applicable regulations including CCR § 2641.1 et seq.;
>
> (2) if a rate decrease is indicated effective July 15, 2015, whether and how much Applicant must pay as refunds and interest based on excessive premiums paid by policyholders between July 15, 2015, and the date Applicant implements the new rate;
>
> (3) if Applicant is able to justify a rate increase effective July 15, 2015, the hearing may extend to any surcharges Applicant may wish to collect based on undercharges to policyholders between July 15, 2015, and the date Applicant implements the new rate; and
>
> (4) any other appropriate relief.

(Notice of Hearing, June 22, 2015, at 3:15-22.)

A. State Farm Has the Burden of Proof.

As an initial matter, State Farm has the burden of proof. (Ins. Code, § 1861.05(b) ["The applicant shall have the burden of proving that the requested rate change is justified and meets the requirements of this article."]; see also 10 CCR § 2646.5 ["The insurer has the burden of proving, ***by a preponderance of the evidence, every fact necessary to show that its rate is not excessive***, inadequate, unfairly discriminatory, or otherwise in violation of chapter 9 (commencing with section 1851) of part 2 of

division 1 of the Insurance Code." Emphasis added.].) Accordingly, neither the CDI, CFC, nor CWD has the burden of proof on any issue in contention or any duty to prove the merits of any alternative rate or rate component.

B. Voter-Enacted Proposition 103 and the Prior Approval Rate Regulations Provide the Legal Standards for Review of Rate Applications.

1. *Section 1861.05 of the Insurance Code prohibits approval of excessive rates.*

Insurance Code section 1861.05(a), provides in full:

> ***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. (Emphasis added.)

2. *State Farm's rates must be rejected if not in compliance with the prior approval rate regulations.*

In this hearing, it is uncontested that the maximum permitted earned premium (10 CCR § 2644.2) and the minimum permitted earned premium (10 CCR § 2644.3) calculations reflect the boundaries for "excessive" and "inadequate" rates.[24] (As stated in *20th Century Ins. Co. v. Garamendi* (1994) 8 Cal.4th 216:

> A rate is "excessive" if it is higher than the maximum permitted earned premium. (See Cal. Code Regs., tit. 10, § 2644.1.) It is "inadequate" if it is lower than the minimum permitted earned premium. (See *ibid.*) The commissioner must approve a rate that (as relevant here) falls between the "excessive" and the "inadequate." (See *ibid.*)

(*20th Century Ins. Co. v. Garamendi*, *supra*, 8 Cal.4th 216, 254.)

"While companies remain free to formulate their rates under any methodology, the Commissioner's review of those rates must use a single, consistent methodology." (10 CCR § 2643.1.) "Barring explicit direction from the legislature or the commissioner, the ALJ ***must*** apply the

[24] See, e.g. 10 CCR § 2646.4(b) ["A hearing on a rate application, and a hearing based on the allegation that a rate in effect is excessive, inadequate, unfairly discriminatory or otherwise in violation of chapter 9 (commencing with section 1851) of part 2 of division 1 of the Insurance Code shall be for the purpose of determining whether [¶] (1) the insurer has properly applied the statute and these regulations in calculating the maximum or minimum permitted earned premium; or [¶] (2) the maximum permitted earned premium or minimum permitted earned premium calculated on the basis of the statute and these regulations, should be adjusted as provided in section 2644.27. A request that the maximum permitted earned premium or minimum permitted earned premium should be adjusted is referred to as a "variance request."].)

regulatory formula." (Proposed Decision, *In The Matter of the Rate Application of American Healthcare Indemnity Company*, File No. PA02025379 ("*AHIC*"), July 24, 2003, p. 8, emphasis added; see also Corrected Order Adopting Proposed Decision and Designating Portion of Decision as Precedential, *AHIC*, Aug. 22, 2003, p. 1.)

C. State Farm Also Bears the Burden of Proof for Its Variance Requests.

The regulations, at 10 CCR § 2644.27, set forth the only allowable grounds for any adjustments to the components or output of the Regulatory Formula (10 CCR § 2646.4(b)). Such adjustments are referred to as "variances." Any requests for a formal variance must be strictly scrutinized because the Regulatory Formula is intended to produce a reasonable, nonconfiscatory rate, without a variance. (*20th Century, supra*, 8 Cal.4th at 313 ["the ratemaking formula itself … is designed to yield a nonconfiscatory rate for the individual insurer even before any variance might come into play"].) As mentioned above, the insurer has the burden of proving by a preponderance of the evidence each fact necessary to show that its proposed rate is not excessive, which would include the facts necessary to show that it meets the substantive condition of each particular variance sought. (10 CCR § 2646.5.)

If it is determined that this threshold burden of meeting the substantive standard of a particular variance has been met, the next determination is what, if any, adjustment is appropriate to the particular ratemaking component or the maximum permitted earned premium under the Regulatory Formula as referenced in the particular variance provision. In the case of the leverage factor variance, for example, the amount of adjustment to the leverage factor is mandated by the regulation. (See 10 CCR § 2644.27(f)(3).)

For each variance, including the confiscation variance, State Farm is required to, among other things, demonstrate "the expected result or impact on the maximum permitted earned premium that the granting of the variance will have as compared to the expected result if the variance is denied" (10 CCR § 2644.27(b)(iii)), "identify the facts and their source justifying the variance request" (10 CCR § 2644.27(b)(iv), and "provide documentation supporting the amount of the change . . . that is being proposed" (*ibid.*). Accordingly, State Farm must prove by a preponderance of the evidence both that the amount of adjustment it proposes under each variance is appropriate in light of the facts and supporting

documentation ***and*** that the departure from the maximum permitted earned premium under the Regulatory Formula will not result in an excessive rate in violation of Insurance Code section 1861.05.

IV. STATE FARM FAILS TO PROPERLY APPLY THE REGULATORY FORMULA

A. State Farm Improperly Seeks to Apply a Positive Catastrophe Trend, Which is Based on Improper Data and Is Unsupported, and State Farm Fails to Make an Adjustment for the Oakland Hills Fire, Which Overstates the Long-Term Catastrophe Average.

10 CCR § 2644.5 states:

> In those insurance lines and coverages where catastrophes occur, the catastrophic losses of anyone accident year in the recorded period are replaced by ***a loading based on a multi-year, long-term average of catastrophe claims***. The number of years over which the average shall be calculated shall be at least 20 years for homeowners multiple peril fire, and at least 10 years for private passenger auto physical damage. Where the insurer does not have enough years of data, the insurer's data shall be supplemented by appropriate data. The catastrophe adjustment shall reflect any changes between the insurer's historical and prospective exposure to catastrophe due to a change in the mix of business. There shall be no catastrophe adjustment for private passenger auto liability.

(Emphasis added.)

Here, a negative trend is supported, and at most, the maximum reasonable trend is 0%.

1. *All non-State Farm actuaries agree that State Farm's catastrophe losses are trending downward.*

All non-State Farm actuaries found that State Farm's catastrophes losses are actually trending downward. (See, e.g., Schwartz Rebuttal, at 64:13-14 [stating his "analysis shows a clear downward trend in the California CAT / AIY trend data reported by SFGIC. The downward trend is -1.7% a year."]; Hemphill PDT, at 10:14-16 ["using California data, I calculated a negative 2.1% and determined that a trend of negative 2.0% would be the most actuarially sound trend selection if I were to apply a trend to the historical CAT ratios"]; Priven PDT, at 7:28 – 8:3 ["I have selected an annual trend of -4.0% based on a weighted average of California Fast Track paid catastrophe data and State Farm's California CAT/AIY data. This is consistent with State Farm's 25 year CAT/AIY trend of -3.3% as shown in SFG-CA-HO-00030789."].) Thus, a negative trend is supported.

The CDI actuary, Dr. Rachel Hemphill, selected no trend, which is in effect a 0% trend. (See, e.g., Hemphill PDT, at 8:24 ["I applied no trend."].) Consumer Watchdog's actuary, Allan Schwartz, concluded "the highest trend in the CAT / AIY ratio that is appropriate is 0%, although a small negative

value would also be supported." (Schwartz Rebuttal, at 64:23-24, 64:14 ["The downward trend is -1.7% a year."].)

2. *Outside of the ratemaking context, State Farm itself believes its catastrophe rate is* [redacted].

State Farm's own documents show that it also believes, outside the context of this hearing, that its catastrophe [redacted]. (See, Exh. 305 ["[redacted]."].) State Farm failed to even address, much explain the reason for this inconsistency between its internal documents and its arguments in this proceeding. For this reason alone, the [redacted] issue should be decided against State Farm. State Farm should not be allowed to state one thing in its internal documents, yet argue the exact opposite in its rate application.

3. *State Farm and Ms. Watkins's use of countrywide and Cal Fire data for trending is inappropriate.*

Instead of the California-specific data it used to calculate its long-term catastrophe average, State Farm used countrywide State Farm Group data and Ms. Watkins used Cal Fire data[25] for calculating/evaluating the trend. Each of these data sets is inappropriate.

The regulations state: "Where reliable data exist for California losses, defense and cost containment expenses, ancillary income, commissions, state premium taxes, loss reserves, and unearned premium reserves, those data shall be used" (10 CCR § 2643.6), and "[w]here the insurer does not have enough years of data, the insurer's data shall be supplemented by appropriate data" (10 CCR § 2644.5). Additionally, ASOP 13, "Trending Procedures in Property/Casualty Insurance" provides, in part:

> The actuary should select data appropriate for the trends being analyzed. The data can consist of historical insurance or non-insurance information. When selecting data, the actuary should consider the following:
>
> a. the credibility assigned to the data by the actuary;
>
> b. the time period for which the data is available;
>
> c. *the relationship to the items being trended*; and

[25] Ms. Watkins testified that "[t]he Cal Fire data is derived from an annual statistical record of fires and damage arising from incidents responded to by Cal Fire [California Department of Forestry and Fire Protection] employees within the DPA [Direct Protection Area] of Cal Fire. This data does not cover the entire state of California . . . ." (Watkins PDT, ¶ 64.)

> d. *the effect of known biases or distortions on the data relied upon* (for example, the impact of catastrophic influences, seasonality, coverage changes, nonrecurring events, claim practices, and distributional changes in deductibles, types of risks, and policy limits).

(Exh. 900, § 3.2, at p. 7, emphasis added.)

Here, it has been demonstrated through testimony of the various non-State Farm actuaries that the countrywide data is inappropriate. (See, e.g., Schwartz Rebuttal, at 61:6-7.) The relationship between the two data sets (California vs. countrywide) is limited, and there are known biases or distortions in the data. (See, e.g., Hemphill PDT, ¶¶ 41,42 [discussing problems with the countrywide data].) Even State Farm's consulting actuary, Ms. Watkins, found that "the composition of catastrophe losses by peril are quite different for California vs. Countrywide business. The Countrywide losses are driven by Wind/Hail claims (excluding hurricane), whereas the California losses are driven by Fire claims." (Watkins PDT, at 22:4-7.)

In addition, the Cal Fire data, used by Ms. Watkins to evaluate the trend selection, is not a reasonable data source because: 1) it is not reasonably related to the California catastrophe data being trended; and 2) there are known biases or distortions in the data.

For example, the Cal Fire data is from a non-insurance source, but Ms. Watkins uses it to calculate/evaluate trends for application to insurance losses. (E.g., Watkins PDT, at 24:3-4.) Also, Cal Fire data contains "rough estimates" of damage by firefighters, which are not relatable to the actual insurance losses State Farm seeks to trend. (E.g., Hemphill PDT, ¶ 66; Watkins PDT, ¶ 65.) In addition, the Cal Fire data is entirely fire losses, while only 50% of State Farm's catastrophe losses are from wildfire (see Priven Rebuttal, at 14:1-2); the Cal Fire data includes many non-residential structures, which are not relevant to this filing (*id.* at 14:9-10); and the Cal Fire data excludes an estimated 72% of all California wildfire data from 1987 to 2013 (*id.* at 14:3-8).

Finally, Ms. Watkins use of Cal Fire data is also inconsistent with another section of ASOP 13, which states:

> 3.4 Selection of Trending Procedures—The actuary should select trending procedures after appropriate consideration of available data. In selecting these procedures, the actuary may consider relevant information such as the following:
>
> a. procedures established by precedent or common usage in the actuarial profession;
> b. procedures used in previous analyses;

c. procedures that predict insurance trends based on insurance, econometric, and other non-insurance data; and
d. the context in which the trend estimate is used in the overall analysis.

(Exh. 900, § 3.4, at p. 3.)

Ms. Watkins did not show that Cal Fire data is commonly used in the actuarial profession for trending. She admitted that she has never used Cal Fire data previously, even though she has been involved with at least 10 residential property rate filings in California. She also did not provide any evidence that Cal Fire data can be used to predict insurance trends.[26] (RT, 167:11-22.) Thus, Ms. Watkins's use of Cal Fire data does not comport with Actuarial Standards of Practice.

4. *Ms. Watkins's evaluation of the R-squared statistic is inaccurate.*

In evaluating the trend calculated using State Farm's own California homeowners insurance data, Ms. Watkins examined the R-squared value for the various calculations, and concluded based on these values that there was "too much variability in the underlying ratios and the resulting indications do not fit the data very well." (Watkins PDT, at 21:22-23.) But, as explained by Mr. Schwartz, "the R^2 statistic measures how significantly the slope of the fitted line differs from zero, which is not the same as a good fit. [¶] . . . [T]he coefficient of variation (R^2) is, by itself, a poor measure of goodness-of-fit. [¶ and] . . . the R^2 statistic is not a reliable measure of a good fit." (Schwartz Rebuttal, at 60:10-16, quoting Exh. 750-2, "The Usefulness of the R^2 Statistic" by Ross Fonticella, ACAS.) Moreover, even if R-squared is a reasonable measure, "a low R^2 value could simply be consistent with a 0% trend, or a trend close to 0%." (Schwartz Rebuttal, at 61:1-2.)

Furthermore, the issue of the variability in the State Farm catastrophe trend when evaluated on annual basis can be addressed by examining the data on a multi-year rolling average basis, which is an actuarially accepted procedure that was used by State Farm in this proceeding. (Schwartz Rebuttal, at 63:22-64:1.) Using that methodology Mr. Schwartz found that the annual trend in the State Farm catastrophe experience was downward at -1.7% a year, that "[t]here is more than a 99% probability that

[26] Given State Farm's burden of proof (see, e.g., 10 CCR § 2646.5), this failure to produce any evidence in support of this necessary conclusion is fatal.

the trend in these data is downward" and "[t]he r-squared value of 46% shows that about ½ the variation around the average value is explained by the downward trend."[27] (Schwartz Rebuttal, at 64:13-17.)

5. *State Farm Failed to Properly Adjust for the Oakland Hills Fire.*

The failure to adjust the data for the Oakland Hills Fire is another problem with State Farm's catastrophe load. As explained by Dr. Hemphill, the Oakland Hills Fire, which occurred in 1991, was a 1-in-50 year event. (See, e.g., Hemphill PDT, ¶¶ 71-76 [providing various reasons for treating the fire as a 1-in-50 event].) In other words, "there is a 2% chance of an event of that loss magnitude or higher occurring in any given year." (Hemphill PDT, at 17:12-13.) Including such an event in an average calculation of a data set shorter than 50 years will overstate the value of the average. Here, none of the parties use a 50-year data set for calculating their long-term average. (See, e.g., Exh. 304 [CDI using a 25-year data set]; Exh. 502, p. 1 [CFC using a 25-year data set]; Parties' Joint Submission of Template Calculations, p. 2 [State Farm using 25 & 35 year data sets].) And none of the testimony provided by State Farm (Watkins Rebuttal, ¶¶ 136-138, 140, 141, 145-147) adequately rebuts Dr. Hemphill's testimony on this issue. Thus, State Farm's failure to make this adjustment overstates their long-term catastrophe average.

6. *Summary:*

- All non-State Farm actuaries agree that the overall trend in State Farm's catastrophe losses is negative and at most no trend (or a 0% trend) should be applied;
- Neither the countrywide data State Farm used to calculate trend nor the Cal Fire data Ms. Watkins used to calculate/evaluate the selected trend are appropriate because neither are relatable to the data being trended and there are known distortions in the data;
- One of the primary reasons cited by State Farm's consulting actuary for ignoring the trend calculated using State Farm's actual California data – the r-squared statistic – does not support State Farm's decision to ignore the trend; and

[27] Furthermore, if the suggestion from Ms. Watkins to use an average catastrophe value for historical years that have unusually high value is done on a consistent basis, the indicated annual catastrophe trend is even more downward, at -3.2% a year, with a high R-squared of 85.7%. (RT, 2983:22-2987:9; see also Exh. 758.)

- State Farm's failure to make an adjustment for the Oakland Hills Fire overstates the long-term catastrophe average.

B. State Farm's Substitution for the Regulatory Projected Yield Value Improperly Relitigates the Formula.

State Farm seeks to use an improper value for the projected yield,[28] on two bases. First, State Farm argues that the general, introductory language of the regulation, which states yield is calculated using "the insurer's actual portfolio,"[29] mandates usage of the annual statement of the applicant – State Farm General Insurance Company – and not the "consolidated annual statement," which the regulation specifically states is to be used.[30] Second, State Farm argues that applying the regulations as written would result in "confiscation," which is prohibited by the U.S. Constitution. As explained in section V.B. below, State Farm's substitution of its desired values for the values required by the regulations as the test for confiscation is specifically prohibited by the apposite legal authority. As explained in this section, State Farm is improperly seeking to relitigate the projected yield regulation. This attempt to rewrite the regulations should be rejected.

"While companies remain free to formulate their rates under any methodology, the Commissioner's review of those rates must use a single, consistent methodology." (10 CCR § 2643.1.) "[T]he ALJ ***must*** apply the regulatory formula." (Proposed Decision, *AHIC*, *supra*, July 24, 2003, p. 8, emphasis added.) "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

[28] Since it is based on the projected yield, State Farm is also using an improper investment federal income tax factor, as well, but correction of the yield will also correct this value. (See, e.g., 10 CCR § 2644.18 [" 'Investment federal income tax factor' means 1.0 minus the prospective federal income tax rate on investment income. The prospective federal income tax rate on investment income *shall be calculated using the weighted yield, adjusted for investment expenses, computed in section 2644.20* . . . ." Emphasis added.].)

[29] The full sentence reads: " 'Projected yield' means the weighted average yield computed using the insurer's actual portfolio and yields currently available on securities in US capital markets." (10 CCR § 2644.20(a).)

[30] Again, the full sentence reads, "The weights shall be determined using the insurer's most recent consolidated annual statement, and shall be computed by dividing the insurer's assets in each separate asset class shown on page 2, lines 1 through 9 of the insurer's consolidated statutory annual statement, by the total of lines 1 through 9." (*Ibid.*)

permitted." (10 CCR § 2646.4(c).) This is known as the relitgation bar, which the California Supreme Court has upheld against industry attack in *20th Century v. Garamendi*, *supra*, stating:

> the effect of the 'relitigation bar' is unobjectionable. In adjudication, the judge applies declared law; he does not entertain the question whether its underlying premises are sound. That is as it should be. Otherwise, standardless, *ad hoc* decisionmaking would result. Similarly, in quasi-adjudicatory proceedings, the administrative law judge applies adopted regulations; he does not entertain the question whether their underlying premises are sound. That is also as it should be, and for the same reason.
>
> (*20th Century*, *supra*, 8 Cal.4th at 312.)

The language of the apposite regulation clearly mandates that projected yield be calculated using *the insurer's most recent consolidated statutory annual statement . . . .*" Emphasis added.].) As explained above and shown in Exhibit 13, the consolidated annual statement (now *combined* annual statement) contains the combined data for an entire group of affiliated property casualty insurers. (See, e.g., Exh. 13-001, ¶ 3.) Thus, the Commissioner has determined that it is the *group's* asset distribution that is appropriate to calculate the projected yield for use in the Regulatory Formula.

Nevertheless, instead of following the regulations, State Farm seeks to use an improper asset distribution for its projected yield calculation; State Farm wants to use data from State Farm General's individual annual statement instead of the consolidated annual statement data required by the regulations.[31]

Seeking to use a value other than the one that is explicitly mandated by the regulations is the very definition of relitigation, which is defined as litigation "of a matter already determined by the[ ] regulations." (10 CCR § 2646.4(c).) Thus, State Farm's alternate yield calculations violate the regulations and should not be considered on in this proceeding. It was for this reason that the ALJ struck the vast majority of State Farm's pre-filed direct testimony on this issue. (See, e.g., Final Rulings on

[31] In Exhibit 17, State Farm uses "Yield" and "FIT_INV" values from lines (17) and (18) to calculate the final values in line (37) instead of the values contained on lines (2) and (3), which are "calculated using State Farm Mutual combined annual statement data." The line (17) and (18) values that State Farm uses are "calculated using State Farm General annual statement data." (See Exh. 17, column labeled "Source or Calculation"; see also RT, 474:2-4 [explaining that Exhibit 16 is an updated version of appendix A to Exhibit 13-A of the rate application, which is on page 1-0094]; *id.* at 476:21 – 477:17 [explaining that Exhibit 17 is the same as Exhibit 16, except that it reflects the parties' stipulations on various components to the ratemaking formula].)

Motions to Strike Applicant's Pre-Filed Direct Testimony, Oct 14, 2015, pp. 5-7.) That should be the end of the inquiry.

C. The Proper Projected Yield Value Is 5.84%, not 5.68%.

CDI's expert, Dr. Hemphill, calculated a projected yield value of 5.68%. (See, e.g., Exh. 384, p. 3.) Consumer Watchdog calculates the yield as 5.84%. (See, e.g., Schwartz Rebuttal, at 4:8-11.) And while it did not *use* this value in its rate template calculations, State Farm agrees with CWD that the *calculated* yield value based upon the regulation is 5.84%. (See, e.g., Exh. 1-0094, line (2); Exh. 17, line (2); see also Appel Rebuttal, ¶ 55 [stating that 5.84% is "the yield based on SFMAIC's investment portfolio"].)

As both Dr. Hemphill and Mr. Schwartz testified, there are two reasons for the differences between Consumer Watchdog's yield value and the CDI's. First, CDI used the 2013 annual statement, while CWD used the 2014 annual statement, which was the most recent available as of the date of the updated application (see e.g., Schwartz Rebuttal, at 4:8-9; RT, 2840:2-3). Second, CWD used investment yields as of June 2015, while the CDI used values from September 2014 (see, e.g., Schwartz Rebuttal, 4:10-11; RT, 2840:305 [to be accurate, Dr. Hemphill could not recall the exact months, but she did agree that CWD used "an updated month"]).

While Dr. Hemphill testified that "either way is fair and accurate," she stated she chose to not to use the updated values because "doing the update [ ] would have decreased the indicated rate for State Farm, and [she] didn't want to do something that was just essentially punitive." (RT, 2840:6, 2840:10-13.) Dr. Hemphill further testified that she did not think the regulations mandated which data to use. (RT, 2840:19-20.)

Mr. Schwartz's approach is in compliance with the regulations. 10 CCR § 2644.20 provides, in part, that the yield should be calculated using "***the most recent*** consolidated annual statement," and "[t]he yields should be used, and for each asset class shall be based on an average of ***the most recent available 3 complete months, as of the date of filing***." (Emphasis added.)

Here, the "date of the filing" is August 7, 2015. (See Exh. 1-0001, "Date Submitted" column.) At the time of the filing, the "most recent" annual statement was the 2014 annual statement, and the "most recent available 3 complete months" of yields was the June 2015 data. (Schwartz Rebuttal, at 4:22-25.)

Additionally, on August 4, 2015, the ALJ ordered:

> The decision in this matter shall be based on data through year-end 2014. State Farm shall update its rate application online through SERFF with data through year-end 2014, including the templates and other exhibits required of a rate application no later than **August 7, 2015.**

(Order Following Scheduling Conference of July 31, 2015, Aug. 4, 2015.) The annual statement data is "data" used in the application; thus, per the ALJ's order, the 2014 data should be used. Using the updated yields, which are from 2015, does not violate the ALJ's order, as the bond yields are not State Farm "data" underlying the application, but instead are "commissioner-issued values,"[32] which the regulations mandate must be the most recent values as of the date of the application.

Finally, calculating the investment yield using the procedures mandated by the regulations is no more "punitive" than using the efficiency standard or reserve ratios mandated by the regulations. It is simply applying the regulations, as directed. In certain circumstances, the calculations mandated by the regulations may favor a carrier, in others they do not. It is the ALJ's duty to apply the regulations in either event. By applying the regulations and previous orders in this case, as required, the appropriate projected yield when using the combined annual statement is 5.84%, *not* 5.68%.

V. STATE FARM'S VARIANCE REQUESTS ARE WITHOUT MERIT AND MUST BE DENIED.

A. State Farm Has Not and Cannot Meet the Standard for Granting the Leverage Factor Variance.

The leverage factor is calculated by the Commissioner for each line based on industry-wide national data as the ratio of earned premiums to the average year-beginning and year-end surplus. (10 CCR § 2644.17(a).) As explained above, the leverage factor imputes a standard value for surplus and is used to calculate the profit provision and the investment income factor. (See, e.g., 10 CCR 2644.15

[32] The yield values by asset type are promulgated by the Commissioner, are posted on the CDI website (http://www.insurance.ca.gov/0250-insurers/0800-rate-filings/0200-prior-approval-factors/ "Maximum Permitted Rate of Return & Yields for Investment Income Calculation"), and must be used for every rate application subject to Proposition 103.

[profit factors], 2644.19(b) [calculating variable investment income factor using the "surplus ratio," which is the inverse of the leverage factor (see 10 CCR § 2644.22)]; see also RT, 421:3-19.)[33]

10 CCR § 2644.27(f)(3) sets forth the following "valid bas[i]s for requesting a variance" to the leverage factor, stating:

> That the insurer should be authorized leverage factor different from the leverage factor determined pursuant to section 2644.17 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***. . . . If ***an insurer*** writes at least 90% of its direct earned premium in one line and writes at least 90% of its direct earned premium in California, the insurer will only be authorized one leverage factor adjustment of 0.85. (Emphasis added.)

Granting the leverage factor variance results in two adjustments: the leverage factor is multiplied by 0.85 and the surplus ratio (the inverse of the leverage factor) is divided by 0.85. (10 CCR § 2644.27(f)(3).) The mathematical impact of multiplying the leverage factor and dividing the surplus ratio by 0.85 is to increase the imputed surplus by 17.6%.[34] The impact on the formula of granting this variance is to increase the profit provision and the investment income, with the net effect of increasing the indicated rate. (See, e.g., Terry PDT, ¶ 100; RT, 411:20-24; Appel PDT, at 14:23-15:2.)

Since a properly triggered leverage factor variance imputes *more* surplus into the ratemaking formula, resulting in a higher rate indication, it necessarily follows that for the variance to apply, the investment risks do not have to be just "different," but they should be *more risky*. This does not appear to be an item in dispute, as Ms. Terry agreed that the variance is intended to provide relief to more risky insurers. (See, e.g., Terry PDT ¶ 99.) One general theory for the purpose of the leverage factor variance is that a company with a mix of business that is more risky would need to have more surplus to protect

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[33] See also Terry PDT, at 18:3-5 ("To avoid allowing one insurer more profit than another, the state sets an artificial surplus level for the purpose of establishing a normalized profit allowance."); 10 CCR §§ 2644.15 (containing the "profit factor" calculations, which include the leverage factor); 2644.17(b)**Error! Bookmark not defined.** (providing for "industry-wide leverage factors," which shows that the surplus is an imputed value); 2644.19(b) (variable investment income factor calculation, which in part relies on "the surplus factor," which is the inverse of the leverage factor); 2644.22 (defining "surplus ratio" as "the reciprocal of the leverage factor").

[34] $1 \div 0.85 = 1.17647$.

against the greater risk of loss, and therefore, the formula imputes that greater surplus into the rate calculation. (See, e.g., RT, 411:25 – 412:5.)[35]

The variance contains two explicit requirements, or "prongs": the company 1) must write at least 90% of its direct earned premium in either one line or in California; and 2) must have "a mix of business [that] presents investment risks different from the risks that are typical of the line as a whole." (10 CCR § 2644.27(f)(3).) In this brief, CWD focuses on the second prong.[36]

For the second prong, it is not enough to show only that the company is more risky than the line as a whole or that the company has a mix of business different from the line as a whole. This prong requires a showing of a *relationship* between the two: i.e., State Farm must prove that its mix of business leads to investment risks that are different (and riskier) from the line as a whole. As shown below, State Farm has failed to meet its burden on this request, as: 1) all the evidence points to a conclusion that State Farm, the largest homeowners insurer both in California and in the United States, has a mix of business that is *less* risky than other insurers; 2) the sole piece of evidence State Farm finally relied upon at the hearing to prove it is more risky than the line as a whole – exhibit 25[37] – does not provide a valid and complete comparison and, even if it did, when evaluated appropriately and consistently with actuarial principles, it shows State Farm's mix of business is less risky than average; 3) State Farm's constantly changing story regarding the leverage variance undermines its position, 4) State Farm's preferred method of using countrywide data (which it did not present) again shows that State

[35] Also, it would make little sense for a carrier to be allowed to charge higher premiums, above the standard indicated rate, if it faced *less* risk than other carriers competing in the same line of insurance.

[36] While Mr. Schwartz concluded that State Farm meets the first prong of the test because the applicant, State Farm General Insurance Company, writes 90% of its direct earned premium in California (see Schwartz PDT, 10:22-23), the CDI argues that this first prong should be evaluated on a group-wide basis (see, e.g., Hemphill PDT, ¶ 104). In response to questioning by the ALJ, Mr. Schwartz explained that he has always evaluated the second prong on a group-wide basis, and while he has always evaluated the first prong on a company-specific basis, he did not think it would be wrong to evaluate it on a group-wide basis. (See, e.g., RT, 1190:1-3 ["the regulation isn't 100 percent explicit about what they mean by 'insurer.'"]; *id.* at 1188:15 – 1189:4.) Whether the first prong is evaluated on a company-specific or group-wide basis, though, Mr. Schwartz explained that the second prong should be evaluated on a group-wide basis because that affects the risk of the mix of business. (*Id.* at 1190:9-16.)

[37] Dr. Appel also referred to a study he previously presented in another rate case, but without identifying that proceeding or discussing the study in any detail. As shown later, that study was from a CSAA rate case and clearly demonstrates that State Farm is not entitled to the leverage variance. (Schwartz Rebuttal, at 10:1-14.)

Farm is less risky than the line as a whole; and 5) even if it is found that State Farm is more risky, which it is not, State Farm has failed to show that this is *because* of its mix of business, which is required by the variance.

1. *As an intial matter, the appropriate subject of review for the second prong is the State Farm Group, not State Farm General in isolation.*

Irrespective of whether the 90% threshold of the first prong should be evaluated on an individual company or group-wide basis, the second prong *must* be evaluated on a group-wide basis. There are several reasons for this. First, it is undisputed that being part of a group with the commensurate diversification geographically and across lines of business reduces the risk. (See, e.g., RT, 1188:20-25, 1191:7-13 [Mr. Schwartz]; Hemphill Rebuttal, at 28:3-8; Appel PDT, at 16:69 & fn.12.) Second, it is clear that State Farm itself manages risk on a group wide basis, coordinating the activities of affiliated insurance companies in the group.

State Farm goes to great lengths to assert it operates as a separate and independent company from other insurers in the State Farm Group. However, the evidence is clear that, while State Farm General may be a separate legal entity that complies with minimal requirements to have its own board meetings, accounting, and the like, State Farm Mutual – the sole 100% owner of State Farm General – manages the company on a group-wide basis from risk management to advertising and accounting. (Schwartz PDT, at 17:2 – 24:14.) As AM Best has stated, "The ratings and outlooks reflect State Farm General Insurance Company's (SFGIC) strong risk-adjusted capitalization, excellent overall operating performance and superior business profile as a ***strategic member of State Farm Group***." (Exh. 711-1, emphasis added.)

As Mr. Schwartz explained "SFGIC has only one shareholder – that being State Farm Mutual Automobile Insurance Company (SFMAIC). According to Schedule Y of the 2014 SFMAIC Annual Statement, SFMAIC has 100% ownership of SFGIC. [Exhibit 10-124] That document also indicates that SFGIC is directly controlled by SFMAIC. Hence, whatever committees SFGIC may have, and whatever meetings it may hold, the reality is that SFMAIC completely owns and directly controls SFGIC." (Schwartz PDT, at 23:6-10.)

For example, there is significant overlap between the officers and directors of State Farm General and State Farm Mutual. (See Exh. 714-1.) [redacted]

[redacted] The State Farm Group's advertising is done on a group-wide basis. (See Schwartz PDT, at 21:22 – 22:2.) [redacted] (See, e.g., Schwartz PDT, at 24:5-14.) And third parties recognize the benefits to State Farm General of this [redacted]. (Exh. 325, 711.)

Additionally, other statutory provisions provide guidance as to how to measure the independence of a company from the common ownership group to which it belongs. Section 1861.16(b), for example, provides that an agent or representative of an individual company in a group is required to offer the lowest good driver rate from all companies within that group, unless the company meets certain requirements under subdivision (c). Among the requirements of this "supergroup exception," as it is commonly referred to, are: 1) The business operations of the insurers are independently managed and directed; 2) The insurers do not jointly maintain or share loss or expense statistics, or other data used in ratemaking or in the preparation of rating systems or rate filings; 3) The insurers do not utilize each others' marketing, sales, or underwriting data; and 4) The insurers' sales, marketing, and policy service operations are separate. (See Ins. Code, § 1861.16(c).) While this statute applies to auto insurance, it provides a reference point for what is considered independence in insurance operations. State Farm General clearly does not meet any of these criteria in relation to State Farm Mutual.[38] Therefore, any claims of "independence" should be rejected.

[38] The business operations of State Farm and State Farm Mutual are not independent, since [redacted] (RT, 2278:10-14; compare also Exh. 754 with Exh. 755.) And the fact that ratemaking data are shared is obvious from the State Farm filing itself "Data is for the State Farm Fire and Casualty Company and State Farm General Insurance Company combined" and "While no business is being written in State Farm Fire and Casualty Company at this time, necessary historical State Farm Fire and Casualty Company supporting data has been included where appropriate." (Exh. 1-76, 1-122.) With regard to marketing and sales, State Farm states: "we use cross-selling opportunities to sell across all product lines: P/C, life, and financial services" (Exhibit 712-1), and it advertises its various products together (see Exh. 713-1 – 4). (See also RT, 927:21-23 ["[A]gents' commissions are paid by State Farm General to State Farm agents, who are licensed to sell products for multiple State Farm affiliates."]; RT, 927:8-13 ["State Farm General does not have claims employees. So State Farm General claims-handling services that are done are performed by State Farm employees. It could be Mutual or Fire employees."].)

2. *The overwhelming weight of evidence supports a conclusion that State Farm is less risky.*

State Farm's position that its mix of business is significantly more risky than other insurers is quite simply not credible or believable. State Farm, as a member of the largest property/casualty insurance group in the state and the nation, which writes 1 in 5 homeowners insurance premium dollars, both in California and countrywide – benefits from both geographic and line of business diversification, as well as from a sophisticated enterprise risk management system. Those facts alone lead to the conclusion that State Farm should be less risky than average. And a reasonable, rational evaluation of the facts confirms that belief. In marked contrast, not only does State Farm claim it is more risky than average, State Farm's position is that it is *the most risky* insurer. (See, e.g., Exhibit 25 [showing State Farm has the highest "scaled" standard deviation of all those presented].) Not only does State Farm expect us to believe that it is more risky than the line as a whole, but according to Dr. Appel's scaled standard deviation calculations in Exhibit 25, State Farm is *three times* as risky as average homeowners insurance in California. (See Schwartz Rebuttal, at 29:9-11.) On its face, it is not plausible to believe that a company with more than 20% of the market share has such an unusual book of business that it is 3 times as risky as the market as a whole. (*Id.* at 29:11-14.) In fact, State Farm's own words contradict the position it has taken in this case regarding risk: State Farm has stated "we are a conservatively managed company that avoids excessive risk taking."[39]

A review of the facts shows that State Farm is far from risky. For example, Mr. Schwartz testified: "SFGIC, by being a large writer of homeowners insurance has less relative risk from catastrophes in California than do other insurers." (Schwartz PDT, at 14:2-3.)[40] Dr. Hemphill provides another example in her pre-filed direct testimony; she cites an AM Best release that highlights the fact that State Farm Mutual and its affiliates "comprise the largest personal lines insurance group in the United States" in reaffirming its strong financial ratings of the company. (Hemphill PDT, ¶ 115, citing Exh. 325.) In fact, AM Best gives both State Farm General and State Farm Mutual a Financial Strength Rating of "A" and an Issuer Credit Rating of at least "a." (Exhs. 325, 711.)

[39] Exhibit 182.

[40] Dr. Appel agrees with this analysis and conclusion of Mr. Schwartz. (See Appel Rebuttal, at 7:8-11.)

Also, Mr. Schwartz has shown that companies selling these lines in California are less risky than the line as a whole nationally. For example, Mr. Schwartz reviewed the historical operating profits for homeowner insurance in each state from 1985 to 2013,[41] and the results showed that California has had a higher than average profit, a lower than average standard deviation of profit and a more positive upward trend in profits. (Schwartz PDT, at 13:1-5.)[42] California also has a lower than average exposure to catastrophe for homeowners insurance. (*Id.* at 15:1 – 16:8; see also Schwartz Rebuttal, at 33:17 – 36:21.) Thus, by virtue of operating in California – and comprising 20% of the California market – State Farm's book is less risky than the line as a whole.

While Dr. Appel alleged that California has a higher than average catastrophe risk nationwide,[43] there are numerous problems with Dr. Appel's analysis, including the fact that he ignored hurricane risk, which is obviously a significant catastrophe risk nationwide. (See, e.g., Schwartz Rebuttal, at 34:18 – 36:21.) Dr. Appel attempted to dismiss this as not important (RT, 2355:9 – 2356:13), but once again Dr. Appel's CSAA study contradicts him. Comparing three State Farm companies that mostly operate in a single state – State Farm General, State Farm Florida, and State Farm Lloyds – shows what a large issue hurricane risk is in states other than California. State Farm Florida has a standard deviation 4 times as high State Farm General, and State Farm Lloyds, which writes business in Texas, has a standard deviation twice as high as State Farm General.[44]

[41] Mr. Schwartz also ran this analysis through 2014, which is shown in Exhibit 757. The updated data confirmed Mr. Schwartz's analysis as to the data through 2013. (See RT, 2977:4 – 2978:20.)

[42] Dr. Appel criticized the method used by Mr. Schwartz to combine together the standard deviations across states. (See, e.g., Appel Rebuttal, ¶ 30.) However, the method used by Mr. Schwartz is essentially the same method as used by Dr. Appel for both his CSAA study (RT, 2968:25 – 2969:9) and in Exhibit 25. In Exhibit 25, the average Raw Standard Deviation of 0.157 is the average of the twenty values by company shown in the column; 0.157 = (0.168 + 0.136 + 0.137 + 0.163 + 0.088 + 0.213 + 0.169 + 0.113 + 0.260 + 0.190 + 0.102 + 0.133 + 0.187 + 0.256 + 0.126 + 0.061 + 0.133 + 0.171 + 0.202 + 0.139) ÷ 20 Similarly, the average Scaled Standard Deviation of 0.056 is the average of the twenty values by company shown in that column.

[43] Appel Rebuttal, at 15:11 – 16:14.

[44] RT, 2970:5-21.

[redacted] (Schwartz PDT, at 31:2-3; Schwartz Rebuttal, at 30:12 – 31:5; Exh. 720.)

3. *The single piece of evidence State Farm presented that purports to show State Farm General is more risky – Exhibit 25 – is not actuarially sound, and when analyzed correctly, supports a finding that State Farm is not more risky.*

State Farm presented only one exhibit purporting to show that State Farm General is more risky than the line as a whole – Exhibit 25. The ALJ should recall that Exhibit 25 was introduced for the first time during the middle of the evidentiary hearing, and admitted over forceful objections, well after it was clear that State Farm's original arguments in favor of the leverage variance would be rejected. Exhibit 25 is State Farm's Hail Mary pass on the leverage variance, but it, too, falls short.

In Exhibit 25, Dr. Appel "compares the variability of State Farm General's loss experience for California homeowners to the variability of the loss experience for [19] other companies that write California homeowners." (RT, 980:13-15.) He does this by comparing the standard deviation of losses, plus DCCE, for the time period 1998 through 2014. Dr. Appel testified that the chose 1998 as the starting point because "State Farm has essentially been a mono-state property insurer in California since 1998." (RT, 981:22-23.) And he limited the other companies to those that had been continually writing homeowners in California for that time period and written a minimum of $10 million per year for every year during that period. (RT, 982:22-25.) After calculating the standard deviation, the so-called "raw" standard deviation, Dr. Appel then "scaled" the standard deviations to adjust for differences in premium. (RT, 991:23 – 993:11, 995:11-15.) This mathematical calculation purportedly removes the distortion allegedly present based on an assumption that standard deviations across years for different companies

[45] "The NAIC Insurance Regulatory Information System (IRIS) is a collection of analytical solvency tools and databases designed to provide state insurance departments with an integrated approach to screening and analyzing the financial condition of insurers operating within their respective states." (Schwartz, p. 30, fn. 37, quoting exhibit 718-2.)

would vary inversely with the square root of premium. (See, e.g., RT, 1077:3-5 [Appel testimony]; see also Schwartz Rebuttal, at 26:2-14.)

The raw calculations show that State Farm's standard deviation is 17.1% with an average across all companies of 15.7%, while the scaled values show State Farm's value is still 17.1%, but the average has moved to 5.6%. (See Exhibit 25.)

Dr. Appel's methodology is flawed from the outset. It only compares State Farm to 19 of the 116 companies that wrote homeowners insurance in California in 2014. (See also Hemphill Rebuttal, ¶¶ 67-70.) In other words, rather than do a comprehensive analysis in compliance with the language of the variance, Dr. Appel cherry-picked the data he needed to show the conclusion that State Farm wanted him to reach. This is improper.[46]

Even ignoring this fatal flaw, an evaluation of the raw values shows that State Farm's "riskiness" is, at worst, about average. (Schwartz Rebuttal, at 14:21 – 16:2.) Plus, when looking at 11 or fewer years (from 2001 to the present), State Farm's standard deviation is lower than average, and when looking at the last 5 or 6 years, State Farm is substantially lower than average. (Schwartz Rebuttal, at 17:9 – 18:2.)[47] This shows that, even using the measure advanced by State Farm, State Farm General is *less risky* than average in recent years. In fact, when looking at the specific years of data used by Dr. Appel, Mr. Schwartz identified two anomalous years, 2003 and 2004, that substantially skewed the standard deviation upward.[48] (Schwartz Rebuttal, at 19:2-8.) And, Mr. Schwartz determined that the anomaly was, at least in part, attributed to reserving practices, *not actual losses*.[49] (Schwartz Rebuttal, at 20:10 – 23:11.) As stated by Mr. Schwartz,

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[46] In attempting to characterize State Farm's collection of California homeowner's policies as presenting three times the investment risk of the average carrier, Exhibit 25 brings to mind Mark Twain's famous quote, "lies, damned lies, and statistics."

[47] Note that, in its rate application, State Farm uses a standard deviation calculation looking at only six years (Exh. 1-0111), so State Farm must believe that standard deviations calculated using time periods as short as six years is appropriate.

[48] Ms. Watkins acknowledged this anomaly in State Farm's catastrophe losses, which gave unusual results (negative catastrophe losses) and made certain calculations impossible. (RT, 135:4-18)

[49] The actual paid losses were fairly consistent, while the reserve values set by State Farm fluctuated widely. (Schwartz Rebuttal, 22:2-21.)

> [T]he wide swings in the SFGIC reported incurred experience between 2003 compared to 2004 and 2005, *which forms a significant part of the basis of the standard deviation calculations underlying Exhibit 25*, does not represent an actual fluctuation of experience between years. Instead, it is simply an artificial distortion resulting from the wildly varying reserving practices of SFGIC during this time period.

(*Id.* at 23:7-11.)

After removing these two anomalous years from the calculations for State Farm and all the other companies in Exhibit 25, State Farm's standard deviation was well below average over the entire period – 12.9% compare to the average of 15.7%. (Schwartz Rebuttal, at 19:8-13.)[50]

The anomalous results for these two years can be seen in the data included in the State Farm filing, which shows negative catastrophe losses for 2004.[51] So unless policyholders are paying State Farm before a catastrophe occurs, it is clear that there are significant issues with the calendar data reported by State Farm for 2004 and surrounding years. In fact, State Farm's own witness agreed that there were issues with the data collected for those years. (RT, 257:8-11.) Given this situation, it is appropriate and actuarially sound to analyze the results excluding those unusual years.

Finally, Dr. Appel's "scaling" methodology, which purports to show that State Farm is three times more risky than average, is unsupported and flawed in its intent and design. As an initial matter, Mr. Schwartz, who unlike Dr. Appel, is an actuary, found that Dr. Appel's scaling methodology was not actuarially sound or appropriate. (See, e.g., Schwartz Rebuttal, at 24:10-22.) Neither one of State Farm's

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[50] Mr. Schwartz's evaluation and treatment of the two anomalous years is consistent with, in fact required by, accepted actuarial practices. ASOP No. 23, Data Quality, states in part:

> 3.5 Review of Data … whether the actuary prepared the data or received the data from others, the actuary should review the data for reasonableness and consistency … When determining the nature and extent of such a review, the actuary should consider the following: … b. Identify Questionable Data Values - The actuary should review the data used directly in the actuary's analysis for the purpose of identifying data values that are materially questionable or relationships that are materially inconsistent. If the actuary believes questionable or inconsistent data values could have a material effect on the analysis, the actuary should consider further steps, when practical, to improve the quality of the data.

(Exh. 901, p. 4.) Mr. Schwartz carefully evaluated and analyzed the data, whereas Dr. Appel simply did some numerical calculations without making an effort to consider the underlying data or the meaning of the results, which is required by Actuarial Standards of Practice.

[51] Exhibit 1-70.

actuarial witnesses even discussed Exhibit 25, much less rebutted Mr. Schwartz's conclusion. This is true, even though Mr. Schwartz's testimony calling into question the actuarial soundness of Exhibit 25 appears in his *written* rebuttal testimony filed in December 2015, and both Ms. Terry and Ms. Watkins testified orally in January 2016.[52]As Mr. Schwartz testified: 1) the scaling methodology advanced by Dr. Appel – which Dr. Appel provided no authority for[53] – has never been used before in any rate proceeding. (Schwartz Rebuttal, at 14:8-11.) In fact, Dr. Appel admits *he has never used it before* (RT, 1053:9-18); 2) Mr. Schwartz is not aware of anyone else who has proposed using such calculations for any purpose (Schwartz Rebuttal, at 14:13-19); and 3) Mr. Schwartz was unable to identify any publication, much less a peer-reviewed article, evaluating (or even using) this methodology (see Schwartz Rebuttal, at 14:13-19).

Additionally, although State Farm has the burden to prove that the never-before-used scaling methodology it recommended is correct and CWD has no burden to show it is incorrect, Mr. Schwartz did in fact show that the scaling method by Dr. Appel is unsupported. Mr. Schwartz conducted a regression analysis of the underlying data and found that the assumption providing the basis for scaling the values – that the standard deviation varied inversely with the square root of premium[54] – was not supported. (Schwartz Rebuttal, at 26:7 – 27:10.) Instead, Mr. Schwartz discovered that, if anything, *the opposite was true*: for this dataset, "standard deviation is increasing as premium size increases."[55] (Schwartz Rebuttal, at 27:3-4.)

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[52] CWD counsel does not recall and could not find any mention of Exhibit 25 in the transcript of Mses. Watkins and Terry's January testimony.

[53] See, e.g., Schwartz Rebuttal, at 26:2-5.

[54] Recall that the purpose of the scaling calculation was to "control" for alleged distortions in the value because of differences in premium values, based on an assumption that the standard deviations varied inversely with the square root of premium. (E.g., Appel Rebuttal, ¶¶ 17-18.)

[55] Moreover, whether the standard deviation increases, decreases, or remains the same in relation to premium is actually irrelevant, since the entire concept of scaling as proposed by Dr. Appel and State Farm is antithetical to the issue of the leverage factor variance. The amount of premium written *is part* of the mix of business. (See Schwartz Rebuttal, at 29:4-8; RT, 2830:22 - 2831:16 [Hemphill testimony].) Thus, removing the impact of premium size on the investment risk of the mix of business, as part of the analysis of the leverage factor variance, simply does not make any sense, as it takes out one of the factors that should be considered in evaluating the mix of business.

4. *State Farms's changing arguments regarding the leverage variance undermine its credibility.*

State Farm presented at least four different arguments in relation to its leverage variance. Those different positions were contained in State Farm's: 1) filing with CDI; 2) pre-filed direct testimony; 3) additional oral direct testimony; and 4) pre-filed rebuttal testimony. Given all the different versions State Farm presented regarding the leverage variance, it is hard to determine what, if anything, State Farm really believes on this issue.

State Farm's first attempt to justify the leverage factor variance consisted of comparing the asset distribution of State Farm General Insurance Company to that of State Farm Fire and Casualty Insurance Company in its rate application. (See Exh. 1-79.) State Farm concluded that since State Farm General invested in 100% bonds whereas State Farm Fire invested in 80% bonds and 20% stocks, that "State Farm General Insurance Company's mix of business (California-only policies) presents investment risk that is different from the risks that are typical of the line as a whole." (*Ibid.*) It is no surprise that State Farm completely abandoned this argument, as it simply does not make sense.

The second argument State Farm presented was that since State Farm General lacks diversification,[56] it automatically meets the second prong of the leverage variance.[57] However, that exact same argument was previously rejected by Administrative Law Judge Kristin L. Rosi and the Insurance Commissioner in the Mercury Casualty Company homeowners insurance rate case.[58] In its direct testimony, State Farm did not present a single shred of statistical data or analysis in support of its conclusory opinions.

[56] Note that CWD does not agree that there is a lack of diversification: this is State Farm's argument.
[57] See, e.g., Appel PDT, 15:19-22 ["[I] have come to the conclusion that SFG's highly concentrated exposure in a single state does imply greater risk than is typical of the line as a whole, and as a consequence it meets the requirements to be granted the requested variance. I explain the logic and analysis behind this opinion below."].
[58] See Schwartz PDT, at 12:9-20.

State Farm's third argument regarding the leverage factor variance was purportedly the result of a midnight epiphany[59] by Dr. Appel, where he allegedly[60] evaluated and analyzed a massive amount of data the night before and the morning he took the witness stand for this direct testimony.[61,] That study by Dr. Appel was contained in Exhibit 25. As has previously been discussed, that data does not show that State Farm General's mix of business presents investment risks ***higher*** than the risks that are typical of the line as a whole, but in fact State Farm has a ***lower*** risk. That is, the one piece of statistical data and analysis presented by State Farm shows that it is not entitled to the leverage variance.

The final argument presented by State Farm was that a study performed on a countrywide basis makes the most sense.[62] Despite this conclusion that a countrywide study makes the most sense and while Dr. Appel discussed in a vague general manner a study he performed on a countrywide basis,[63] the only data and analysis Dr. Appel presented was on a California-only basis.[64] No explanation was presented by State Farm for why it did not have a study done based on the data its expert witness

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[59] State Farm and Dr. Appel's position that Dr. Appel belatedly discovered this type of analysis regarding the leverage factor variance seems incredulous given the fact that he was previously involved in a rate case where that exact same type of analysis was presented. (See, e.g., Schwartz PDT, at 9:9 – 10:18.)

[60] The position by State Farm that Dr. Appel did this analysis on November 18 and 19, 2015, is directly contradicted by Dr. Appel's testimony that the data were extracted on November 5, 2015, and the analysis was completed no later than November 13, 2015. (RT, 1024:22 – 1025:5.)

[61] MS. WELLS: . . . It wasn't just produced last night, but it was also this morning. So it was last night and this morning that this exhibit was produced.
JUDGE LARSEN: When you say "produced," what -- do you mean it was given to the parties before or --
MS. WELLS: No. No. The study was conducted last night and this morning.
JUDGE LARSEN: Okay. You mean Dr. Appel looked at all his data and came up with these numbers last night?
MS. WELLS: Correct.
JUDGE LARSEN: Okay. In preparation for his testimony?
MS. WELLS: In preparation for his testimony today.
(RT, 964:21-965:3; see also RT, 982:7-21 [Dr. Appel testifying that he reviewed a database with thousands of annual statements].)

[62] See, e.g., Appel Rebuttal, at 2:12-14. The actual data and results of the study were not presented by Dr. Appel or State Farm.

[63] See Appel Rebuttal, at 4:5-21.

[64] See, e.g., RT, 980:4-6, [Dr. Appel testifying that Exhibit 25 "compares the volatility or variability of State Farm General's experience to the variability of other California homeowners insurers."].

believed made the most sense. The reason is obvious because, as discussed below, the previous countrywide study performed by Dr. Appel conclusively demonstrates that State Farm General's mix of business presents investment risks ***lower*** than the risks that are typical of the line as a whole.

From the inception of this process, starting with the filing State Farm submitted to CDI through to the conclusion of the evidentiary hearing, State Farm's alleged basis for why it contends it is entitled to the leverage variance was constantly changing and shifting, without any consistency. The only constant is that each of State Farm's positions was shown to be unsupported with no basis whatsoever, and that State Farm is not entitled to the leverage factor variance.

5. *Dr. Appel's preferred methodology for evaluating the leverage factor variance, which he presented in the CSAA rate case, shows that State Farm does not qualify.*

Dr. Appel agrees that in the context of the leverage variance, the term "line as a whole" could mean California homeowners or countrywide homeowners, but he believes the latter – countrywide – is more appropriate. (Appel Rebuttal, at 2:8-14.) With respect to treating the "line as a whole" as California homeowners insurance, Dr. Appel presented exhibit 25,[65] which is discussed elsewhere in this brief. Regarding treating the "line as a whole" as countrywide homeowners insurance, Dr. Appel referenced an analysis he presented in a different rate proceeding. (Appel Rebuttal, at 4:5-21) Although Dr. Appel never identified that other proceeding, it came from a CSAA rate case. (See RT, 2963:22-25.) It is not surprising that Dr. Appel did not specifically identify or discuss in detail the CSAA analysis because it completely undercuts and contradicts his analysis in this case.

Dr. Appel's analysis in the CSAA case showed that State Farm had a standard deviation of 18.1%, which was lower than the overall countrywide standard deviation of 19.7%. (RT, 2975:7-9; see also Exh. 756.) That is, State Farm has a standard deviation 8% lower than the countrywide homeowners results.[66] Thus, the CSAA study shows that using Dr. Appel's: 1) preferred definition of the line as a whole; and 2) preferred measure of risk based upon standard deviation, State Farm is less risky than the line as a whole. Hence State Farm does not qualify for the leverage variance.

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[65] See Appel Rebuttal, at 3:13-18.

[66] Updating data through the end of 2014 would increase the amount by which State Farm is less risky than countrywide homeowners insurance. (RT, 2975:20 – 2976:1)

There are also many also instances where Dr. Appel's CSAA analysis contradicts his Exhibit 25 analysis in this case. Those include, but are not limited to:

1) Using different criteria to determine which companies to include in the analysis (RT, 2964:24 – 2965:2);
2) Using a different number of years in the analysis (RT, 2967:6-23); and
3) Using scaling in Exhibit 25, but not using scaling in his CSAA study (RT, 2968:12-20).

The multiple inconsistencies between the procedure Dr. Appel used in Exhibit 25, compared to what he did in the CSAA case, raises serious concerns regarding the reliability of Dr. Appel's leverage variance analysis in this case, especially considering that Dr. Appel asserted that the type of analysis he conducted in CSAA was his preferred view of the leverage factor variance. This begs the question of why didn't Dr. Appel use the same CSAA methodology in this proceeding if he believes it is the proper way to analyze whether the requirements for the leverage factor variance have been met? The answer is obvious: it is because using the methodology Dr. Appel espoused in CSAA would clearly show that State Farm is not entitled to the leverage variance.

6. *Even if State Farm is more risky, which it is not, State Farm has not shown (and cannot show) that this is due to differences in State Farm's mix of business from the line as a whole.*

Even assuming that State Farm is more risky, which it is not, State Farm has failed to meet its burden of showing that this is due to State Farm's mix of business. The regulation requires that the "*mix of business* presents investment risks that are different from the risks that are typical of the line as a whole," not just that the insurer is more risky than the line as a whole. For example, the variance might be granted to an insurer that can prove its mix of business presents more investment risk than is typical of the line as a whole because it only writes insurance in San Francisco, but should not be granted to an insurer that is more risky because of inaccurate reserving practices.[67] In the latter scenario, the fact that the company's inaccurate reserving practices make it ***appear to be*** more risky means it does not meet the requirements of the variance because the apparent greater riskiness is not due to its mix of business.

[67] See, for example, the discussion of State Farm's reserving practices in section **Error! Reference source not found.**, *infra*.

Here, State Farm's evidence on its mix of business in relation to the leverage factor variance is exceptionally sparse. The only specific testimony about State Farm's overall mix of business came from Ms. Terry. She testified that State Farm writes approximately 20% of the California homeowners market, its "exposure is spread throughout the state," and therefore it is likely that State Farm policyholders will be impacted by any given catastrophe. (Terry PDT, ¶ 103.) That's it. Standing alone, which it is, this testimony is not sufficient to determine that State Farm's mix of business is different from the line as a whole, much less whether it is related to any additional riskiness of State Farm.

On the other hand, Dr. Appel has presented the standard deviation of losses plus DCCE as evidence that State Farm is more risky. Even accepting Dr. Appel's analysis that State Farm has a greater than average standard deviation of losses plus DCCE, there has been no evidence to show that such riskiness is because of State Farm's mix of business.

In fact, it is much more likely and reasonable to conclude that a company that writes 20% of the business in one line, as State Farm does in California and countrywide,[68] is going to have a mix of business and investment risks that are, if anything, very similar to "the line as a whole," and because of that mix of business, large size, and diversification, is less risky than the line as a whole. As to the geographic diversity cited by Ms. Terry as leading to more riskiness, Dr. Appel testified that increasing geographic diversity lowers risk. (See, e.g., Appel PDT, ¶ 31.)[69] And, as explained by Mr. Schwartz,

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[68] For countrywide data, see Exhibit M, attached to CWD's Request for Official Notice, filed concurrently with this brief.

[69] In fact, in comments to the Commissioner regarding the leverage factor calculation, which were made on behalf of the Pacific Association of Domestic Insurance Companies, Dr. Appel specifically stated that the leverage factor was particularly punitive to small insurers because:

> the amount of surplus currently held by the industry reflects the fact that many insurers (and ***all of the largest insurers***) are substantially diversified, selling multiple lines of business in many states.[fn] As mentioned earlier, since diversification confers a benefit in terms of risk reduction, the insurance industry in the aggregate can hold less surplus than it otherwise would absent its diversified business activities.
>
> [fn] Consider that there are more than 1000 ***insurance groups*** operating in the U.S. Of those, the top 25 account for approximately two thirds of industrywide premium and surplus. To the extent that these firms can hold smaller amounts of surplus per dollar of premium because of diversification, the industrywide average amount of surplus will be substantially lower than would be required for smaller, less diversified firms

State Farm's large size, while potentially subjecting it to more catastrophes, creates *less uncertainty* about the impact of catastrophic events and more certainty about potential losses, thus supporting a finding of less riskiness. (See Schwartz PDT, at 14:5-22.) In fact, Dr. Appel stated he *agrees* with Mr. Schwartz's analysis on this issue. (Appel Rebuttal, at 7:8-11.)

In sum, even if State Farm appears to be more risky, which it has not shown, it has failed to prove that this increased riskiness is due to its mix of business, which is required by the regulation.

B. State Farm's Confiscation Variance Request Fails on All Points.

State Farm also requests variance 9, which may be granted if it is demonstrated "[t]hat the maximum permitted earned premium would be confiscatory as applied." (10 CCR § 2644.27(f)(9).) As the regulation states, "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."

As explained in footnote 1 of the Parties' Joint Submission of Template Calculations, "[t]he calculations underlying [State Farm's] Variance 9 are shown in Exhibit 17." A review of the evidence shows that State Farm is simply substituting in a projected yield calculation using the asset distribution in State Farm General's ***individual*** annual statement, instead of State Farm's consolidated annual statement as required by the regulations.[70] State Farm claims that it will *forever* be unable to earn a fair rate of return if it is required to use the combined annual statement to calculate projected yield, as the regulations require. (See, e.g., State Farm Motion to Strike Brief, *supra*, at 18:16-18.) And State Farm bases this conclusion on State Farm General's voluntary choice[71] to invest its entire portfolio in bonds, which have a lower yield than common stocks, while State Farm Group's portfolio, which the regulations mandate State Farm use to calculate its yield, has about 42% common stock. (See, e.g., 701-

(Exh. 734-2.) The State Farm Group is the largest property/casualty and homeowners insurer in the country, and State Farm General *itself* is the largest homeowners insurer in the state and the ninth largest in the country, even though it only writes in California. (See Schwartz Rebuttal, at 28:6-11.) Thus, not only did Dr. Appel indicate that larger insurers, like State Farm, need less surplus, he also evaluated this issue on a *group-wide* basis, as CWD argues should be done here.

[70] As explained in footnote 31 above, State Farm uses "Yield" and "FIT_INV" values from lines (17) and (18), which use State Farm General annual statement data, to calculate the final values in line (37) of Exhibit 17, instead of the values contained on lines (2) and (3), which are "calculated using State Farm Mutual combined annual statement data."

[71] And, since State Farm Mutual is the 100% owner of State Farm General, this is practically speaking, State Farm Mutual's choice.

2 [$64.5 billion in common stock (line 4) ÷ $152 billion total assets (line 10) = 42.43%].) As such, State Farm argues that the projected yield is lower than what State Farm General will actually realize. (State Farm Motion to Strike Brief, *supra*, at 15:17-21.) It is worth noting that the projected yield calculated using State Farm General's annual statement, which State Farm uses to show alleged confiscation, is *lower* and the investment income tax rate is *higher* than what State Farm itself actually believes it will earn on its investments. (Compare Exh. 1-114 [projecting a 3.5% yield for the rating period based on historical results] to Exh. 17, line (37) [projected yield of 2.64%]; compare also Exh. 1-115 [projected investment federal income tax factor of 14.5% for State Farm for the rating period] to Exh. 17, line (18) [investment federal income tax factor of 17.78%]; see also RT, 2083:1-23, 2088:10-13, 2082:4 – 2088:13.)

State Farm's request for a confiscation on this ground should be denied because State Farm has not provided any evidence relevant to whether it will be unable to operate successfully under the rate as calculated pursuant to Regulatory Formula, which is required to prove confiscation. (See *20th Century*, *supra*, at 296 ["In a word, the inability to operate successfully is a necessary-but not a sufficient-condition of confiscation."].)

1. *<u>20th Century v. Garamendi</u> provides the applicable standards for confiscation, which require, at a minimum, a showing of an "inability to operate successfully."*

In *20th Century*, the California Supreme Court applied the constitutional protections embodied in the due process and takings clauses of the U.S. Constitution to uphold the Commissioner's ratemaking regulations, both facially and as applied. (*20th Century*, *supra*, 8 Cal.4th at 291, 297, 328.) As articulated by the Court, when a regulation is challenged as being confiscatory as applied, "***the question is whether***, in the particular case, ***its terms set a rate that is unjust and unreasonable and hence confiscatory***." (*Id.* at 318, emphasis added.) The Court went on to state, "[j]udicial inquiry as to whether or not a rate is just and reasonable is also limited." (*Ibid.*) Indeed, such an inquiry by the court is "at an end" "[i]f the total effect of the rate order cannot be said to be unjust and unreasonable…The fact that the method employed to reach that result may contain infirmities is not then important." (*Ibid.*, quoting *Power Comm'n v. Hope Gas. Co.* (1944) 302 U.S. 320, 602; see also *20th Century*, *supra*, 8 Cal.4th at 292-293.)

As the established U.S. and California Supreme Court precedent further elucidate***, whether a rate "is unjust and unreasonable in its consequences and therefore confiscatory depends on a balancing of the interests of [the insurer] and its insureds***." (*Id*. at 325, emphasis added; see also *id*. at 293-295; *Hope, supra*, 320 U.S. at 603 ["[T]he fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests"].)

In applying the *Hope* balancing test, the *20th Century* Court noted that insureds have an interest in "freedom from exploitation." (*Id*. at 325.) On the other hand, the insurer has an "interest" in "a 'return to the equity owner' that is 'commensurate with returns on investments in other enterprises having corresponding risks' and 'sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.'" (*Id.* at 325-326, emphasis added, citing and quoting *Hope*, *supra*, 320 U.S. at 603 [discussing the "investor interest" in "the financial integrity of the company whose rates are being regulated"].) The Court emphasized that this insurer "interest, however, is just that: it is an *interest*, not a *right*" and is "'only one of the variables in the constitutional calculus of reasonableness.'" (*Id*. at 326, emphasis in original, citing *In Re Permian Basin Area Rate Cases* ("*Permian Basin*") (1968) 390 U.S. 747, 769.) The Court held that an insurer "has no constitutional right to a profit" [citation omitted] and "[i]ndeed, it has no constitutional right even against a loss." (*Id*. at 294, 326.)

The Court continued:

> In attempting to balance producer and consumer interests, one may of course arrive at a rate that disappoints one or even both parties. But a striking of the balance to the producer's detriment does not necessarily work confiscation. Indeed, it can *threaten* confiscation only when it prevents the producer from "operating successfully."

(*20th Century*, *supra*, 8 Cal.4th at 295, emphasis in original.)[72]

The *20th Century* Court further explained:

> The *Hope* court itself expressly held that "[r]ates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, ***even though***

[72] Accord *Galland v. City of Clovis* (2001) 24 Cal.4th 1003, 1026 ("[W]ithin this broad zone, the rate regulator is balancing the interests of investors, [], with the interests of consumers, [] in order to achieve a rent level that will on the one hand maintain the affordability of the mobilehome park and on the other hand allow the landlord to continue to operate successfully," citing *Kavanau v. Santa Monica Rent Control Bd.* (1997) 16 Cal.4th 761, 778-779.)

> ***they might produce only a meager return***....” (*Power Comm’n v. Hope Gas Co., supra,* 320 U.S. at p. 605, 64 S.Ct. at p. 289.) A year later, the court restated this holding in even simpler terms in a unanimous opinion by Justice Jackson: “a company [cannot] complain if the return which was allowed made it possible for the company to operate successfully.” (*Market Street R. Co. v. Comm’n, supra,* 324 U.S. at p. 566, 65 S.Ct. at p. 779.)

(*Ibid*., emphasis added.)

Accordingly, confiscation requires a showing by the insurer that “***the rate in question does not allow it to operate successfully***.” (*Ibid.*, emphasis added; *Hope, supra*, 320 U.S. at 605.) “In a word, the inability to operate successfully is a necessary-***but not a sufficient***-condition of confiscation.” (*20th Century*, *supra*, 8 Cal.4th at 296, emphasis added.)

The *20th Century* Court further explained that:

> “absent the sort of deep financial hardship described in *Hope*,” [] “there is no taking....” (*Jersey Cent. Power & Light Co. v. F.E.R.C., supra,* 810 F.2d at p. 1181, fn. 3.) This follows from the fact that, under *Hope*, a regulated firm may claim that a rate is confiscatory only if the rate does not allow it to operate successfully. In such circumstances, the firm is not inaptly characterized as experiencing “deep financial hardship” as a result of the rate.

(*Ibid.*)

The *20th Century* Court also determined that confiscation “does *not* arise”: 1) “whenever a rate simply 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’” (*id.* at 297); or 2) when the Commissioner uses formulaic ratemaking by, for example, using industry averages for expenses or the leverage factor (*id.* at 285-90; see also *id.* at 285 [“he may proceed by formula rather than case by case. Indeed, it is arguable that he *should* proceed in that fashion,” emphasis in original]). Additionally, “confiscation is judged with an eye toward the regulated firm as an enterprise” and not a particular line of insurance. (*20th Century*, *supra*, 8 Cal.4th at 293, emphasis added; see also *id*. at 308-309 and 322 [same].)

A determination of “confiscation” thus involves a factual determination of the actual effects of implementing a particular rate on the totality of State Farm’s business, not an abstract analysis of why, in State Farm’s self-serving view, the Commissioner’s chosen methodology for calculating the projected yield is unfair to this one company in the insurance group. Instead, State Farm must demonstrate that its entire enterprise will be unable to operate successfully when the proposed rate is enacted. State Farm

has not and cannot make the required showing because it has fail to offer any evidence relevant to the finding necessary to show confiscation.

2. *State Farm's "independent company" argument has no bearing on the confiscation analysis, because confiscation looks to the "enterprise as a whole."*

As stated above State Farm's primary argument in support of its confiscation variance requests rests on its assertion that State Farm General is an independent company that has independently decided to invest all of its assets in bonds, whereas the State Farm Group has approximately 42% of its assets in common stocks. By State Farm's own admission the decision to segregate State Farm General's assets from the rest of the group was a voluntary business decision made by State Farm Mutual, State Farm General's parent and 100% owner. (E.g., Larson PDT, ¶¶ 10, 19).

Furthermore, by State Farm's own admission, as reflected in the State Farm Mutual Annual Statement, which is filed with the California Department of Insurance and signed under oath by the Chairman of the Board, President and Chief Executive Officer of State Farm, State Farm General Insurance Company is "Directly Controlled by" State Farm Mutual Automobile Insurance Company.[73] Contrary to the fiction that State Farm keeps espousing, State Farm General is not operationally an independent company. The reality is that the operations of State Farm General are integrated and coordinated with the operations of the other companies in the State Farm Group. The evidence shows that State Farm Mutual manages its property and casualty affiliates – including State Farm General – on a group-wide basis from risk management to advertising and accounting. (See Schwartz PDT, at 17:2 – 24:14.) And, State Farm General's officers and directors are [redacted] (RT, 2278:10-14; compare Exhs. 754 with Exh. 755.) There is no legal reason why State Farm Mutual could not change State Farm General's investment portfolio to match those in the State Farm Group's annual statement.[74]

Moreover, State Farm has identified no barrier to State Farm Mutual reorganizing its inter-company arrangements such that State Farm General could have the same asset distribution as State

[73] Exh. 10-124.

[74] While State Farm Mutual and State Farm General are two separate legal entities, the fact that State Farm Mutual is the 100% owner of, and directly controls, State Farm General means that the actions of those two entities are intertwined, not independent of each other, and State Farm Mutual has final authority over any of State Farm's business decisions.

Farm Mutual or simply share in the investment returns of the Group. Instead, State Farm General relies on the fact that it does not *currently* participate in any inter-company pooling arrangement as support for its claims that it is *forever* barred from earning a fair rate of return.

Here, the Commissioner's has determined that the combined annual statement is appropriate because companies in a common ownership group are permitted to, and commonly do, share finances and risk across companies. State Farm itself admits that *many* companies that operate within a common ownership group have inter-company arrangements to do just this. (E.g., Appel Rebuttal, ¶ 45.) And, the fact that sharing risk among the companies is one of the benefits of participating in a common ownership group is undisputed. (See, e.g., RT, 1188:20-25, 1191:7-13 [Schwartz]; Appel PDT, ¶ 29-33; RT, 956:24 – 957:22 [Appel]; Hemphill PDT, ¶¶ 110-127.) It necessarily follows that these companies would also share income, like investment returns. (See, e.g., Spiker Rebuttal, ¶ 7.) Furthermore, even if companies do not actually share income, insurance companies within a group coordinate decisions regarding operations, risk and investments. There is no doubt, and in fact there is a wealth of evidence demonstrating, that is what State Farm does.

This is one of the many reasons why the confiscation question requires a review of the "enterprise as a whole." Otherwise, companies might, for example, argue that its business decision to (at least on paper) segregate an undercapitalized or poorly run segment, affiliate, or product line from the rest of the enterprise, necessarily result in confiscation. Here, the Commissioner has determined that companies involved in a common ownership group can, and many times do, participate in intercompany pooling agreements in which they share both risk and reward (e.g., investment returns). As such, the Commissioner has determined that the consolidated/combined annual statement is the appropriate asset distribution to use for yield. The fact that State Farm Mutual – the 100% owner of State Farm General – has made a decision to not do that is of no consequence.

In fact, the "enterprise as a whole" that is looked to for determining confiscation should be the common ownership group. Otherwise, insurance groups could simply create a legally separate business entity for each individual product line or geographic area (like State Farm has done here) in order to game the system. As shown below, State Farm General is projected to make a profit on this rate, and

both State Farm General and State Farm Group have enjoyed substantial returns under the prior approval regulatory scheme.

3. *State Farm's "end result" test shows nothing relevant to whether the rate calculated by applying the Regulatory Formula will result in an inability to operate successfully.*

Instead of presenting evidence relevant to determining whether the rate is confiscatory, State Farm's "evidence" in support of variance 9 is contained in Exhibit 17, which it calls "an illustration of the end result, measured by the rate of return produced by the formula, of substituting State Farm Mutual's combined basis asset distribution for that of State Farm General." (E.g., Exh. 1-0093.[75]) That bears repeating. Exhibit 17 does nothing more than substitute the asset distribution contained in State Farm General's annual statement into the projected yield calculation for the distribution contained in the State Farm Group's consolidated annual statement, the latter of which the regulations mandate must be used for the projected yield calculation. (See also RT, 428:17-25 [Ms. Terry agreeing that this is an accurate statement of what appendix A does].) As explained above, this is nothing more than an attempt to alter the mandate of the regulations, which is improper relitigation. This should be the end of the inquiry, and the variance should be denied.

The question is not whether ***some other*** rate component or methodology might be fair or reasonable. The question, as made clear by *20th Century* (and all the case law on this issue) is whether the rate ***as set by the regulator***, in this case the rate indication created by application of the Regulatory Formula, is just and reasonable such that it will not result in an "inability to operate successfully." (*20th Century*, *supra*, 8 Cal.4th 216 at 292.) State Farm has conceded that its only basis for showing confiscation relies on straying from the Regulatory Formula.

Were State Farm's argument accepted, whenever an insurer disagreed with the Commissioner's regulations, then the matter would suddenly become a debate over confiscation.[76] The result would be

[75] Exh. 1-0093 refers to "Exhibit A," which is at Exh. 1-0094.

[76] This same method of turning a disagreement with the Regulatory Formula into a confiscation issue was used by Mercury Casualty Company in its 2009 rate hearing. (See, e.g., Proposed Decision on Remand, *In Re: the Rate Application of Mercury Casualty Company*, Jan. 28, 2013, p. 121 ["[M]ercury 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

that the regulatory formula would be rendered meaningless. This was not the intent of the regulations and finds no support in the established legal precedent.

In addition to the legal defects in the State Farm argument, it also suffers from factual problems.

First, even under State Farm's own calculations, it will earn profits of tens of millions of dollars from writing homeowners insurance in California. State Farm's supposed end-result test shows "Total Profit after Tax % Premium" of 2.41% to 3.25%.[77] (Exh.17, Line (33).) On a premium base of about $1.1 billion,[78] the resulting projected ***after-tax profit*** ranges from about $27 million to $36 million. That result cannot reasonably be described as either an inability to operate successfully or deep financial hardship.

Second, by State Farm's own admission, the calculations in Exhibit 17 do not reflect an end-result test, even under State Farm's incorrect legal argument. Exhibit 17 is based upon a before tax-investment yield of 2.40% (Line (17) – "YIELD") and an investment tax rate of 17.78% (Line (18) – "FIT_INV"). However, those are not the actual values State Farm General expects to achieve during the rating period. State Farm expects to earn a higher investment yield of 3.5% and have a lower investment tax rate of 14.5%. (See Exhs. 1-114, 115; see also RT, 2083:1-23, 2088:10-13.) As a result, the values used by State Farm in its end-result test understates the expected investment income, and overstates the projected federal income taxes, both of which depress the indicated profits, even under State Farm's incorrect legal theory of how confiscation should be measured.

4. *State Farm has been extremely profitable under the rates resulting from the Regulatory Formula to date, and the evidence shows that it will continue to be so.*

The evidence submitted by CWD shows—convincingly—that State Farm has and will continue to be extremely profitable under California's regulatory scheme.

For example, a review of profits on a countrywide basis on all lines shows that from 2010

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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."].) Both the Commissioner and the courts have rejected this methodology of seeking an alternative calculation for a component to the Regulatory Formula and claiming confiscation when denied.

[77] State Farm originally calculated the value to be 3.63% to 4.14% (see Exh. 1-94), which was corrected after cross-examination of Ms. Terry identifying problems in the calculation (see RT, 475:11-478:7).

[78] Exhibit 1-9, Adjusted Earned Premium.

through 2014, all while operating under the Regulatory Formula, State Farm General realized net income (i.e., profit) of $1.59 billion, an average profit after taxes of $318 million per year. (See Schwartz, at 26:24 – 27:8.) In 2013 and 2014 alone, State Farm General reported total net income after taxes of $732 million. (See *id*., 27:4-6.) Looking at the enterprise as a whole – i.e., the State Farm Group– in the five-year period from 2010 through 2014, the State Farm Group reported net income after taxes of $12.22 billion – an average of $2.4 billion per year – and profited $4.6 billion in 2014, alone.

In response to this evidence, which was in Mr. Schwartz's pre-filed direct testimony, State Farm complained that Mr. Schwartz only looked at a five-year time period. (See, e.g., Appel Rebuttal, ¶¶ 53, 54; see also RT, 1168:5-11, 1169:2-10.) Even though a five-year time frame is commonly used,[79] Mr. Schwartz reviewed additional years in his rebuttal. Going back to 2005, which was the last year he had available, State Farm General averaged comparable profits: nearly $300 million per year.[80] And from 2005 to 2014, the State Farm Group averaged $2.485 billion per year in profits. (Schwartz Rebuttal, 49:16 – 50:5.)[81]

Under the Regulatory Formula, State Farm General is projected to earn $119 million annually from the rate calculated pursuant to the Regulatory Formula.[82] And as explained above, *even using State Farm's preferred calculation* – using State Farm General's asset distribution but denying State Farm the leverage factor variance – *State Farm General would earn about $27 million annually in the*

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[79] For example, this is the time frame the ALJ in *In re Mercury Casualty Company, PA-2006-00006*, evaluated for confiscation. (Proposed Decision on Remand, *In Re: the Rate Application of Mercury Casualty Company*, Jan. 28, 2013, p. 114 ["Mercury's five year average net income as a percent of surplus equals 11.7%.]."). And five years is the time frame mandated for insurers, including State Farm, to use in their annual statements. (See, e.g., Schwartz Rebuttal, at 42:19-23; see also Exh. 8-45, line 18 [showing net income during the five year period from 2010 to 2014, and the values match those presented by Mr. Schwartz and decried by State Farm].) State Farm itself used only six years to calculate its underwriting profit in its preferred ratemaking methodology, which is shown in exhibit 14 to the Rate Application (hearing Exhibit 1). (See Exh. 1-0111.)

[80] (See Schwartz Rebuttal, at 47:17 – 48:22.) 2005-2014 is 10 years, and $2,996.37 billion ÷ 10 years = $299.64 million.

[81] No larger time frame would be appropriate because the projected yield regulation in its current form was not implemented until 2007. (See, e.g., Final Regulation Text, RH05042749, Jan. 3, 2007, p. 15 [attached to the concurrently filed Request for Official Notice as Exhibit M].)

[82] $1.123 billion [adjusted earned premium] x 10.63% [maximum profit from templates] = $119.4 million.

homeowners line for California alone.[83] Case law and common sense mandate that a $27 million profit cannot be considered confiscatory. (See, e.g., *20th Century v. Garamendi*, *supra*, 8 Cal.4th at 294 [" 'A regulated [firm] has no constitutional right to a profit . . . .' [Citations.] Indeed, such a firm has no constitutional right even against a loss."].) State Farm's request for the confiscation variance is analogous to a multi-millionaire seeking welfare benefits. In State Farm's world, making hundreds of millions (or even billions) in profits is equated with suffering serious and threatening financial struggles. We should all have State Farm's problems. State Farm has utterly and completely failed to meet its burden of proof on the confiscation variance, and its request should be denied. The numbers speak for themselves. State Farm has failed to prove that even just its homeowners line in California would suffer confiscation.

The variance request should be denied.

VI. STATE FARM'S CURRENT RATES ARE EXCESSIVE AND REFUNDS SHOULD BE ORDERED.

Section 1861.05 prohibits excessive rates from being approved *and* from "remain[ing] in effect." The data and evidence presented in this hearing shows not only that State Farm is *not* entitled to the increase it requested, but also that State Farm's *current rates* are excessive, and as a result, approximately 1.7 million[84] State Farm policyholders have been overcharged by $285,000 per day just since July 15, 2015.[85] As of the date this brief is submitted, the accrued overcharges to State Farm's homeowners' policyholders are over $77 million, plus interest, and counting. This exact scenario is one of the reasons Proposition 103 contains the "remain in effect" language, which authorizes refunds when insurers overcharge consumers. Under the plain language of the law and to implement the purpose of the

[83] $1.123 billion [adjusted earned premium] x 2.41% [Total Profit after tax % Premium from Exh. 17, line (33)] = $27.1 million. Again, the 2.64% value used here was calculated using a projected yield that is lower than what State Farm itself actually believes it will earn. (See, e.g., Exh. 1-114 [showing projected 3.5% yield based on historical results]; see also RT, 2082:4 – 2085:15 .)

[84] Exh. 1-0015, line 12.

[85] State Farm's last rate change took effect on May 15, 2014. (See Exh. 1-0037.) Shortly thereafter, on December 4, 2014, State Farm filed the rate application that began this proceeding seeking a rate increase of 6.9%. (See, e.g., CWD Petition for Hearing, Petition to Intervene, and Notice of Intent to Seek Compensation, Jan. 26, 2015, ¶ 1.) On June 22, 2015, the Commissioner issued a Notice of Hearing, which, among other things, stated that the effective date of rates calculated in this proceeding would be July 15, 2015.

statute – to protect consumers – State Farm must be ordered to issue refunds to its policyholders.

A. The Voters Passed Proposition 103 to "Protect Consumers" from "Excessive, Unjustified and Aribtrary Rates," and the Proposition Is to Be "Liberally Construed and Applied in Order to Fully Promote Its Underlying Purpose."

On November 8, 1988, California voters passed the citizen-backed Proposition 103. The voters recognized that "[t]he existing laws inadequately protect consumers and allow insurance companies to charge excessive, unjustified and arbitrary rates." (Prop. 103, Stats. 1988, § 1.) The specific purpose of Proposition 103 is "to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." (*Id.* at 2.) And Proposition 103, section 8(a) provides "that the act 'shall be liberally construed and applied in order to fully promote its underlying purposes.'" (*Foundation for Taxpayer and Consumer Rights v. Garamendi* (2005) 132 Cal.App.4th 1354, 1354, *as* modified (Oct. 27, 2005), quoting Prop. 103.)

It is also instructive to note that the idea of refunds for violations of Proposition 103 is not novel or extraordinary. For example, pursuant to section 1861.03, the Proposition 103 voters – for the first time – subjected the business of insurance to the Unfair Competition Law (Bus. & Prof. Code §§ 17200, et seq.), the Consumers Legal Remedies Act (Civ. Code § 1770, et seq.) and the Unruh Civil Rights Act (Civ. Code § 51, et seq.), among others. And it is without question that restitutionary disgorgement (i.e., refunds) and/or damages is an available remedy under each these statutes. (See, e.g., Bus. & Prof. Code § 17503 ["The court may make such orders or judgments . . . as may be necessary to restore to any person in interest any money or property, real or personal, which may have been acquired by means of such unfair competition."]; Civ. Code §§ 52 [Unruh Act remedies] 1780(a) [CLRA remedies]; see also *Cortez v. Purolator Air Filtration Products Co.* (2000) 23 Cal.4th 163, 176-77 [discussing cases where restitutionary disgorgement was awarded under the Unfair Competition Law].)[86]

[86] In fact, Insurance Code section 1858.3 contained broad language authorizing the Commissioner to order refunds in relation to a noncompliance action, even before the passage of Proposition 103. Section 1858.3(a), provides, in part, that the Commissioner may "direct the insurer or rating organization to take *such other corrective action as he or she may deem necessary and proper*." While beyond the scope of this proceeding, the Legislative history of this language, enacted in 1977, makes clear it was added to give the Commissioner access to retrospective remedies, like refunds.

B. The Prohibition on Excessive "In Effect" Rates Includes Refund Authority.

The evaluation of the meaning of a statute must begin with the plain text of the law:

> In determining intent, we first examine the words of the statute itself . . . . Under the so-called 'plain meaning' rule, courts seek to give the words employed by the Legislature their usual and ordinary meaning . . . . If the language of the statute is clear and unambiguous, there is no need for construction . . . .

(*Donabedian v. Mercury Insurance Co.* (2004) 116 Cal.App.4th 968, 976, quoting *Bodell Construction Co. v. Trustees of Cal. State University* (1998) 62 Cal.App.4th 1508, omissions in original.)

Section 1861.05 (a) establishes the rate review process and the governing standard. It requires that "[n]o rate shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of this chapter." Note this section specifies oversight of two different types of rates: 1) prospective rates; and 2) "in effect" rates.[87] The simple fact that these two conditions are separate and apart in the statute makes clear that the "excessive, inadequate unfairly discriminatory" standard applies not only to future rates, but also to rates that are "in effect," clearly establishing the Commissioner's authority in this proceeding to regulate current rates and obtain retrospective relief, if necessary.[88]

The California Supreme Courts historic decision upholding the validity of Proposition 103, expressly confirms this analysis. In *Calfarm*, among other things, insurance companies claimed that Proposition 103 did not contain procedures sufficient to protect insurers from having to charge confiscatory rates pending administrative review. (*Calfarm Ins. Co. v. Deukmejian*, *supra*, 48 Cal.3d 805, at 823.) In evaluating the statute, the Court determined that, contrary to the insurers' contentions, the statute contained very few requirements, and instead of "establish[ing] detailed method[s]" for setting rates, the statute contained broad, generalized language that allowed for discretion in how to carry out the dictates of the statute. (*Id.* at 824.)

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[87] CWD believes that the prohibition on excessive "in effect" rates exists in no other state in the nation, as CWD and its counsel are unaware of, and were unable to find, any similar statutes.

[88] The use of the term and retrospective is not intended to implicate the jurisprudence regarding the retrospective effect of a statute, nor should it. (See, e.g., *Calfarm Ins. Co. v. Deukmejian* (1989) 48 Cal.3d 805, 826-27; see also, e.g., *Evangelatos v. Superior Court* (1988) 44 Cal.3d 1188, 1206 ["[a] retrospective law is one which affects rights, obligations, acts, transactions and conditions which are performed or exist prior to the adoption of the statute," internal quotes omitted.].) The issue here is whether Proposition 103 grants the authority to issue orders regarding rates that have already been charged, not whether a newly enacted statute or regulation applies to past activities.

In particular, the Court held that the "in effect" language in section 1861.05(a) includes the authority to grant "interim relief" for rates, *including ordering refunds*, stating:

> The power to grant interim relief is necessary for the due and efficient administration of Proposition 103, and may fairly be implied from its command that "[n]o rate shall ... *remain in effect* which is excessive, inadequate, unfairly discriminatory or otherwise in violation of this chapter." (§ 1861.05, subd. (a).) (Italics added.)
>
> . . . as we have explained, the commissioner can approve an interim rate pending her final decision. If the commissioner finds the initiative's rate, or ***some other rate less than the insurer charged, is fair and reasonable, the insurer must refund excess premiums collected with interest***.

(*Calfarm Ins. Co. v. Deukmejian*, *supra*, 48 Cal.3d at 825, final emphasis added.)[89]

The Court based its holding on the broad "in effect" language of section 1861.905(a), and the fact that, unlike other statutes, Proposition 103 set forth its mandates in general terms but delegated to the elected Commissioner the responsibility to determine how best to administer the law consistent with the statute's terms. (*Ibid*.) To be clear, the Court held that in order to protect *insurers* from confiscatory rates, the Commissioner could order interim rates while the correct rates were determined and then order refunds if the "in effect" rates were found to be excessive.

Just as the "in effect" language was found to authorize refunds in the furtherance of protecting insurers from confiscatory rates, the same language protects consumers from excessive rates. This statutory analysis is strongly supported by the purpose and intent of the law. When the rates that are "in effect" are excessive, the insurance is not "fair" or "affordable," but rather in violation of the plain intent and *explicit purpose* of Proposition 103 to prohibit excessive rates from "remain[ing] in effect." CWD, the CDI, and CFC all agree that State Farm has been charging excessive rates since at least July 15, 2015. If State Farm is allowed to keep tens of millions of dollars in illegally excessive premiums, the purposes of Proposition 103 are thwarted. Thus, requiring insurers to return overcharged premiums is clearly in the interests of consumers and in line with the purposes of the statute.

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[89] Moreover, this kind of refund authority is not controversial. In *Public Utilities Commission of Ohio v. United Fuel Gas Co.* (1943) 317 U.S. 456, for example, the U.S. Supreme Court noted that general language granting the Public Utilities Commission of Ohio the authority to order rates "during the period so fixed by the ordinance" permitted retroactive ratemaking, which in turn allowed for refunds. (*Id.* at 463; see also *id.* at 464 [holding that the statute authorizing refunds, although valid, was not applicable, while the applicable statute did not allow refunds because it authorized setting rates "to be thereafter" charged].)

Finally, apart from the plain language of the text and the Supreme Court's unequivocal emphasis upon the refund authority, as quoted above, Proposition 103 is to be "liberally construed and applied in order to fully promote its underlying purposes." The authority to order refunds is demonstrably necessary to effectuate the protections of Proposition 103.

C. Refunds Are Necessary to Enable Enforcement of the Statute, and to Reduce the Job to a Manageable Size.

In addition to the clear language and purpose of the statute, *Calfarm* also held that Proposition 103 grants the Commissioner the authority to "exercise such additional powers as are necessary for the due and efficient administration of powers expressly granted by statute, or as *may fairly be implied* from the statute." (*Id.* at 824.) *Calfarm* also held that the Commissioner may "tak[e] whatever steps are necessary to reduce the job to manageable size." (*Id.* at 824.) The inherent and implied authority conferred by the statute necessarily includes the authority to order refunds, because otherwise the "in effect" language of the statute could not be enforced.

In a rate proceeding such as this, there will always be a period of time between the date upon which rates became excessive and the date of the Commissioner's order determining those rates were excessive. For example, in this proceeding, the parties were granted time to conduct discovery, including bringing motions to compel (see 10 CCR § 2655.1). The regulations also mandated that State Farm file its written testimony at least *forty (40) business* days prior to the hearing (10 CCR § 2655.6). After the conclusion of the initial direct evidentiary hearing, the parties demanded an opportunity to present rebuttal testimony, which the regulations permit and require to be filed in writing. (See 10 CCR § 2655.9.) Then, the parties had to find a mutually convenient time to come back for oral rebuttal. Now, the parties have eight weeks for post-hearing briefing (10 CCR § 2657.1). After that, the Administrative Law Judge has thirty days to file a proposed decision and the agency has up to 100 days to issue its decision. (See Govt. Code § 11517(c).) With all these steps, the parties have taken nine months already, and it will likely be at least a year between the issuance of the Notice of Hearing on July 22, 2015, and the Commissioner's order.

Thus, when it is determined that the rates in effect have been excessive, implementing this premium refund authority is essential. Otherwise, an insurance company such as State Farm would always have the incentive to prolong and delay the rate review process without any negative

consequences, all while knowing that every day it did so, it could continue collect, and keep, illegal premiums from policyholders. Prop 103 was enacted for the specific purpose of protecting consumers from excessive rates. Only by ordering refunds would this purpose be served.

As noted above, Proposition 103 generally, and section 1861.05(a) specifically, unmistakably place insurance companies doing business in California on notice that their rates must be *fair* – neither excessive nor inadequate – at all times. The Commissioner's approach to his responsibility to enforce the "in effect" requirement through refunds is sensible and efficient. The alternatives – the Commissioner forcing a full-blown rate hearing every four months for each line of insurance for on every insurance company doing business in California, for example – would be completely unmanageable.

D. The Effective Date of the Rates Calculated in this Proceeding is July 15, 2015, So the Premium for Any Policy Issued After that Date Should Be Re-Calculated and Any Decrease Refunded With Interest.

Here, following the Commissioner's hearing order, the parties have calculated the rates *as of* July 15, 2015.[90] (See, Order Following July 31 Scheduling Conference, Aug. 4, 2015, p. 4 ["For the purposes of the hearing, the effective date of State Farm's rate application shall be July 15, 2015."].)[91] Thus, if it is determined that a rate reduction is appropriate as the evidence presented by the CDI, CFC, and Consumer Watchdog demonstrates, then that rate reduction was appropriate at least as of July 15, 2015. State Farm should be ordered to refund policyholders for premiums it overcharged starting on that date. That is, for all policies where a decrease is found to be appropriate on or after July 15, 2015, State Farm should be ordered to recalculate the premium, which is a simple calculation for State Farm, and refund any overcharge.

In addition, as required in *Calfarm,* State Farm "must refund excess premiums collected ***with interest***" (*Calfarm*, 48 Cal.3d at 825, emphasis added). This is no different than civil courts awarding prejudgment interest, which is a common practice. (See, e.g., 6 Witkin, Summary 10th (2005) Torts, §

[90] The Commissioner's choice of the effective date governs this proceeding only, of course. The statute is clear that the rates that are in effect must *never* be excessive. Thus, refunds can and should be required effective any date that a rate becomes excessive.

[91] The regulations provide support for using the Regulatory Formula to calculate an "in effect" rate. (See 10 CCR § 2646.4(b) [stating that both "[a] hearing on a rate application, *and a hearing based on the allegation that a rate in effect is excessive*" shall apply the Regulatory Formula].)

1643, p. 1160; Civ. Code § 3287 ["Every person who it entitled under any judgment to receive damages . . . may also recover interest thereon from a date prior to the entry of judgment . . . ."].) The California Constitution sets a default interest rate of 7%, so that is a reasonable rate to be applied here. (See, e.g., Cal. Const., art. XV, § 1 ["The rate of interest upon the loan or forbearance of any money, goods, or things in action, or on accounts after demand, shall be 7 percent per annum. . . . . [¶] In the absence of the setting of such rate by the Legislature, the rate of interest on any judgment rendered in any court of the state shall be 7 percent per annum."].)

E. State Farm's Rights Will Not Be Infringed by A Refund Order.

Like all insurers doing business in California, State Farm is well aware of the "remain in effect" language, which places a continuing duty upon insurance companies, independent of the Commissioner, to maintain rates that are neither excessive nor inadequate (i.e., the statute puts the insurer on notice that excessive rates cannot "remain in effect."). Moreover, in this proceeding State Farm was explicitly placed on notice that the rates being examined are its rates as of July 15, 2015, and State Farm has received a full hearing on those rates.

VII. CONCLUSION

State Farm has failed to meet its burden of proof as to any and all issues in contention in this matter. The proposed rate hike should be denied.

In addition, the evidence has shown that State Farm's current rates are excessive, in contravention of Proposition 103, and have been excessive since at least July 15, 2015. Therefore CWD respectfully requests that the ALJ order that State Farm's current rates must ***be reduced by at least 9.26% and order refunds of all excessive premiums charged since July 15, 2015***.[92]

DATED: April 11, 2016

CONSUMER WATCHDOG
Harvey Rosenfield
Pamela Pressley
Jonathan Phenix

[92] As stated previously, should the ALJ adopt the catastrophe values proposed by either the CDI or CFC, the resulting rate will be even lower.

ZOHAR LAW FIRM, P.C.
Daniel Y. Zohar
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By: 

Todd M. Foreman
Attorneys for Intervenor, Consumer Watchdog

PROOF OF SERVICE

Re: ***In the Matter of Rate Application of State Farm General Insurance Company,*** **File No. PA-2015-00004**

I am employed in the County of Los Angeles; I am over the age of 18 years and not a party to the within action; my business address is 601 S. Figueroa Street, Suite 2675, Los Angeles, CA 90017.

On April 11, 2016, I served the foregoing document(s) described as: **CONSUMER WATCHDOG'S POST-HEARING OPENING BRIEF (PUBLIC-REDACTED)** on the interested parties in this action by placing a true copy thereof, in a sealed envelope(s) addressed as follows:

SEE ATTACHED SERVICE LIST

___ MAIL- as follows: I am "readily familiar" with the practice of Zohar Law Firm, for collection and processing of correspondence for mailing with the United States Postal Service and that correspondence placed in the outgoing mail tray in my office for collection would be deposited in the United States Mail that same day in the course of business.

___ PERSONAL SERVICE- I caused such sealed envelope to be delivered by hand to the office(s) of the addressee(s) set forth above.

___ FACSIMILE- I caused a true and complete copy of the document(s) described above to be transmitted by facsimile transmission to the telephone number(s) of the person(s) at the address(es) set forth above.

_X__ BY ELECTRONIC MAIL/E-MAIL- I caused a true and complete copy of the document(s) described above to be transmitted by e-mail transmission to the e-mail address(es) of the person(s) set forth above.

___ FEDEX/OVERNIGHT COURIER- I caused such sealed envelope to be deposited in a collection box for the next day delivery to the person(s) at the address(es) set forth above.

_X_ (State) I declare under penalty of perjury that the foregoing is true and correct.

___(Federal) I declare under penalty of perjury that the foregoing is true and correct, and that I am employed in the office of a member of the bar of this Court at whose direction the service was made.

Executed on April 11, 2016, at Los Angeles, California.

Jeanette Eun

SERVICE LIST

Re: ***In the Matter of Rate Application of State Farm General Insurance Company,*** **File No. PA-2015-00004**

Hon. John H. Larson Chief Administrative Law Judge **Administrative Hearing Bureau** **California Department of Insurance** 45 Fremont St., 22nd Floor San Francisco, CA 94105 Tel: (415)538-4102 Fax: (415)904-5854	
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