

Application No.: A.17-03-xxx

Exhibit No.: SDGE-02

Witnesses: Stephen Johnston

PREPARED DIRECT TESTIMONY

ON BEHALF OF

SAN DIEGO GAS & ELECTRIC COMPANY

**(DESCRIPTION OF THE UNREGULATED SUBSIDIARY AND ITS INTERACTIONS
WITH SDG&E)**

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**

March 30, 2017

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1 **I. GENERAL DESCRIPTION OF THE PROPOSAL**

2 As discussed in the testimony of Mr. David Geier (Exhibit (“Ex.”) SDGE-01), San Diego
3 Gas & Electric Company (“SDG&E”) has developed Intellectual Property (“IP”) and has
4 obtained or applied for patents for certain IP. To increase the availability of the IP in the
5 marketplace and optimize the value of the IP for SDG&E and its ratepayers, SDG&E intends to
6 form an unregulated subsidiary (“the NewCo Subsidiary” or “NewCo Sub”) as a separate legal
7 entity to which the IP rights could be transferred (i.e., sold or licensed) for commercialization
8 (“the Proposal”).

9 Under the Proposal, every transfer of IP rights from SDG&E to the NewCo Sub will be
10 observed and reviewed by an Independent Evaluator. Every transfer also would be subject to
11 approval by the California Public Utilities Commission (“Commission”) under Section 851 of
12 the California Public Utilities Code. To standardize and facilitate Commission review, SDG&E
13 proposes a framework for future Section 851 filings for any sale of IP or IP licensing agreement
14 by SDG&E to the NewCo Sub. Part of the framework is a proposed standardized sharing
15 mechanism between SDG&E’s ratepayers and shareholders of any financial compensation
16 received by SDG&E from the NewCo Sub for the IP rights. Both proposals are discussed in my
17 testimony.

18 As discussed in this testimony, SDG&E requests waivers of certain Affiliate Transaction
19 Rules¹ (“ATRs” or “Rules”). SDG&E has determined that the waivers are needed for the
20 NewCo Sub to be competitive in the open market. This testimony describes the commercial

¹ *Affiliate Transaction Rules Applicable to Large California Energy Utilities* (“ATR”), available at:
<http://docs.cpuc.ca.gov/PublishedDocs/PUBLISHED/GRAPHICS/63089.PDF>, approved by D.06-12-
029 (amending D.97-12-088), at Ordering Paragraph 1.

1 basis for the requested waivers. Additional information about SDG&E’s request for certain ATR
2 waivers is discussed in the testimony of Ms. Diana Day (Ex. SDGE-03).

3 **II. DESCRIPTION OF THE NEWCO SUB**

4 The purpose of the NewCo Sub will be to help commercialize innovations, especially IP
5 and related products that can be used by utilities and the energy industry in California and across
6 the country. Its main activities will include, but not be limited to, managing business
7 development efforts, commercializing IP and patents, and marketing and distributing IP
8 products. While the NewCo Sub will likely focus mostly on SDG&E-developed IP, it will not be
9 restricted to commercializing only SDG&E-developed IP; it can pursue other commercial
10 activities. The NewCo Sub will primarily target geographic markets outside of SDG&E’s
11 territory, but it could also commercialize the IP both inside and outside of SDG&E’s service
12 territory.

13 The NewCo Sub will be a separate corporate entity from SDG&E² and will be subject to
14 the Affiliate Transaction Rules, except for the requested waivers discussed in Ex. SDGE-03. As
15 such, it will not use “SDG&E” or a variation of “SDG&E” in its name or branding, and it will
16 not use the SDG&E name or logo. It will use the disclaimer appropriate to covered affiliates of
17 SDG&E.³ The NewCo Sub will operate in a physically separate space from SDG&E in
18 compliance with the Rules.⁴ The NewCo Sub will keep its own accounting books and records.⁵
19 The NewCo Sub may obtain support services from the market or may obtain allowable shared

² See ATR V.A, p. 10.

³ See ATR V.F, pp. 13-14.

⁴ See ATR V.C, p. 11.

⁵ See ATR V.B, p. 11.

1 services from SDG&E or from SDG&E's parent company, Sempra, as permitted by the ATRs.⁶
2 Cost accounting and controls will be established and employed by SDG&E that align with
3 affiliate separation policies. SDG&E will maintain a record of all contracts and related offers
4 received for any IP rights licensed to the NewCo Sub in compliance with the Rules.⁷

5 The NewCo Sub will be governed by a Board of Directors. The Board of Directors will
6 not involve itself in day-to-day operations of the NewCo Sub and will not be involved in
7 negotiations for IP between third parties or the NewCo Sub. Rather, it will oversee the
8 management of the NewCo Sub to conduct its business and mission to pursue IP
9 commercialization.

10 SDG&E is requesting a waiver to allow SDG&E employees to serve as officers or on the
11 Board of Directors of NewCo Sub. SDG&E shareholders will fund the NewCo Sub, so allowing
12 shared officers or directors will allow SDG&E to oversee its shareholders' investments. Shared
13 SDG&E employee's time will be tracked to properly allocate the cost between SDG&E and the
14 NewCo Sub. Shared officers and directors will not hold positions in either company that would
15 allow them to become informational conduits between SDG&E and the NewCo Sub during
16 negotiations and other commercially sensitive periods.⁸ As an additional check, an Independent
17 Evaluator will be retained during each IP negotiation process to observe and review the
18 evaluations, negotiations and selection process to ensure that no preferential treatment was given
19 to the NewCo Sub by SDG&E.

⁶ See ATR V.E, p. 12-13.

⁷ See ATRs IV.F and IV.G, p. 10.

⁸ See ATR V.G.1, pp. 14-15.

1 The NewCo Sub will be staffed by its own employees or contractors, except as allowed
2 by the Rules.⁹

3 The NewCo Sub will be initially funded by SDG&E shareholders, but it may seek
4 financing from other sources. Costs and activities of the NewCo Sub will be exclusively at
5 SDG&E shareholder risk. Because the NewCo Sub will be a separate legal entity from SDG&E,
6 the NewCo Sub is designed to bear the burden of its own financial and legal risks including, but
7 not limited to, financial losses, litigation related to the NewCo Sub's products sold, and other
8 risks that commercial ventures often face.

9 **III. PROPOSED PROCESS TO NEGOTIATE AND TRANSFER IP RIGHTS FROM** 10 **SDG&E TO THE NEWCO SUBSIDIARY**

11 From time to time, SDG&E decides whether to pursue an agreement to sell or license its
12 IP to a third party. The process that SDG&E typically follows is described below in Section
13 III.A.

14 Once the NewCo Sub is established, SDG&E may also decide to pursue an agreement to
15 sell or license its IP rights to the NewCo Sub. SDG&E intends to follow the same process as the
16 one used for third party agreements, except that SDG&E will retain an Independent Evaluator
17 throughout the process. These steps are described below in Section III.B.¹⁰

⁹ When the NewCo Sub is formed, any initial transfer of employees will be done in compliance with Rule V.G.2 (pp. 11-12). Rule V.G.2.e allows employees not involved in marketing to be used on a temporary basis (less than 30% of chargeable time) by affiliates not engaged in energy marketing under specific conditions. Any employee transfers or loaned labor will be done in compliance with the Rules.

¹⁰ The proposed process drives the need for certain waivers of the Affiliate Transaction Rules, as described in the testimony of Ms. Day (Ex. SDGE-03).

1 **A. Evaluation and Negotiation Process with Third Parties**

2 Typically, when SDG&E has IP that it believes could be commercialized, SDG&E seeks
3 third parties to which it could sell or license rights to its IP in exchange for a one-time payment,
4 fees, royalty payments, or other forms of financial compensation. Figure 1 illustrates the steps
5 SDG&E usually takes when evaluating and negotiating IP agreements with third parties.

6 Figure 1



7
8
9 The process typically begins by evaluating the attractiveness of the opportunity and the
10 ability to succeed in the target market for the IP. This involves determining which criteria most
11 affect the likelihood of commercialization success and then identifying third parties that seem
12 strong in those criteria. Examples of key criteria are strategic alignment with current products or
13 services, financial strength, existing capabilities in the target market for the IP, and other varied
14 factors whose importance will depend on the specific IP that is being considered.

15 The next step is to solicit interest from third parties. This involves developing a value
16 proposition to explain why third parties should be interested in paying for the IP. It requires
17 contacting potential buyers and identifying the decision makers within those organizations.

18 During this phase of the process, SDG&E usually executes a nondisclosure agreement
19 (“NDA”) with any third party that is interested so that confidential information may be shared.
20 Such information may include, but is not limited to, research and development results, related
21 inventions and IP, technical and engineering information, and market research information
22 directly related to the IP. Technical information may be exchanged to determine the ability of

1 the third party to support the product or service. Market analysis reports or financial projections
2 may be exchanged to determine the potential value of the IP. This exchange of information
3 allows interested third parties to validate or modify assumptions and perform the due diligence
4 necessary to develop an offer (or decline to offer) to purchase or license the IP.

5 After exchanging and analyzing this information, SDG&E evaluates the potential third
6 party partners and any offers received. This involves determining the level of interest from each
7 third party, gathering more information to validate or modify any original assumptions about the
8 opportunity, and evaluating each third party's ability to succeed in the target market. SDG&E
9 will select the offer that provides the best potential result for itself and its ratepayers.

10 If an offer is accepted, SDG&E negotiates with the third party for suitable commercial
11 terms and financial compensation. Part of the agreement with the third party is for payment for
12 selling or licensing rights to the IP to the third party. This payment often takes the form of a
13 royalty percentage of future sales by the third party,¹¹ but could also be a one-time payment or
14 other compensation. The agreement also provides the limitations of liability for SDG&E. These
15 sales or licensing agreements with third parties are always subject to Commission approval
16 pursuant to Section 851.

17 Once an agreement is executed by the parties and approved by the Commission, SDG&E
18 continues with on-going management of the agreement. This involves maintaining contact with
19 the IP licensee, auditing for performance on terms of the agreement, and addressing any
20 contractual obligations.

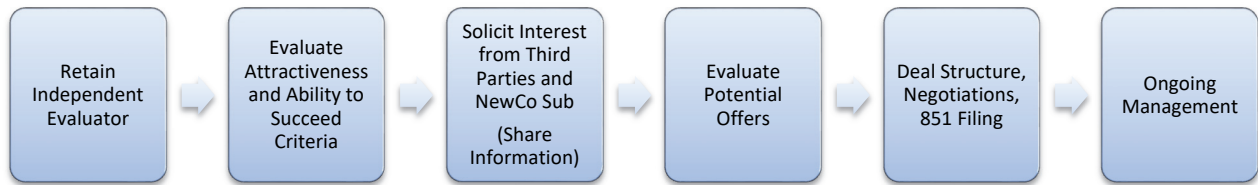
¹¹ See, e.g., Advice Letter 2982-E (submitted October 5, 2016; currently pending).

1 **B. Evaluation and Negotiation Process with the NewCo Sub**

2 The following process is designed so that SDG&E can evaluate offers from NewCo Sub
3 against offers from other third parties.

4 In the event the NewCo Sub is a potential buyer or licensee for SDG&E IP, SDG&E will
5 follow the same process outlined above in Section A, with the additional procedural safeguard of
6 retaining an Independent Evaluator throughout the process. Figure 2 illustrates the steps that
7 SDG&E plans to take when evaluating and negotiating IP agreements with third parties and the
8 NewCo Sub.

9
10 Figure 2



11
12
13 In the proposed process, any time SDG&E envisions soliciting interest from the NewCo
14 Sub, it would retain an Independent Evaluator to observe and review the entire process. SDG&E
15 would solicit interest from the NewCo Sub contemporaneously with third parties. Ideally, more
16 than one entity will express interest in purchasing or licensing the IP. Having more than one
17 entity negotiating for an IP license is designed to set a fair market price for the IP, and optimize
18 the financial compensation for the IP rights that SDG&E (and its ratepayers) receive. If it is
19 interested, the NewCo Sub (and any interested third parties), will express its interest to SDG&E.
20 Then SDG&E would need to exchange non-public information with any interested third parties,
21 including NewCo Sub, during the initial evaluation process so that all parties may perform their

1 due diligence. Parties interested in receiving and exchanging non-public information, including
2 the NewCo Sub, would be required to first sign an NDA.¹²

3 Sharing non-public information with the NewCo Sub would require a waiver of certain
4 ATRs, as discussed in more detail in Ex. SDGE-03. After evaluating the information, the third
5 parties and the NewCo Sub will decide if they are interested in obtaining rights to the IP from
6 SDG&E and, if so, submit an offer to SDG&E.

7 SDG&E will then evaluate potential third party partners and their initial offers. The IP
8 that SDG&E has developed and may develop in the future is broad in scope and marketability;
9 therefore, it is difficult to specify a single set of criteria that would govern the evaluations of
10 offers. Since offers from different parties might not contain identical terms, SDG&E will
11 determine which factors are important, compare the offers received, and will select which
12 company (or companies) to sell or license the rights to the IP.

13 SDG&E does not have to select only one third party through this process; it may decide
14 to enter into a non-exclusive IP agreement with two or more parties.¹³ If no third party offers are
15 received, and the NewCo Sub is the only offer, then SDG&E may select the offer from NewCo
16 Sub. If multiple offers are received, SDG&E will select the offer that provides the best potential
17 result for itself and its ratepayers. The NewCo Sub will never be obligated to license the IP from
18 SDG&E, and SDG&E will not be required to sell or license its IP to the NewCo Sub. Once an
19 offer is accepted, SDG&E will enter contract negotiations for suitable commercial terms, liability

¹² No private customer-specific data or personally identifiable information of SDG&E customers would be provided to the NewCo Sub or other third parties.

¹³ For example, Advice Letter 2982-E (submitted October 5, 2016; currently pending).

1 limitations and financial compensation.¹⁴ Any rights to the IP provided to the NewCo Sub will
2 be governed by the negotiated agreement. The financial compensation received from the NewCo
3 Sub may take a variety of forms, such as a recurring revenue stream (such as an annual fee or a
4 royalty on net sales revenues), or if the IP is sold, a single one-time sale. SDG&E will document
5 any agreements with the NewCo Sub in compliance with the Rules.¹⁵

6 Akin to other agreements with third parties, any agreements to sell or license IP to the
7 NewCo Sub will be submitted to the Commission for approval. Section V below discusses
8 SDG&E's proposal for standardized Section 851 submissions involving the NewCo Sub.

9 Once an agreement is executed and approved by the Commission, SDG&E will continue
10 with on-going management of the agreement. If the NewCo Sub is commercializing the IP,
11 SDG&E will maintain contact with the NewCo Sub, audit for performance on terms of the
12 agreement, and address any contractual obligations. Independent auditors may be used as
13 needed to ensure compliance with the Rules and the requested waivers.

14 Throughout this entire process, SDG&E will use a qualified Independent Evaluator who
15 has the requisite skills to evaluate IP sales and licensing deals. The Independent Evaluator will
16 observe the process throughout the evaluation and negotiation steps to evaluate whether
17 SDG&E's activities and decisions were fair, reasonable, and performed with no preferential

¹⁴ SDG&E employees involved in negotiating IP rights will not be loaned to the NewCo Sub to ensure they do not act as conduits for information about the offers during IP negotiating activities, per Rule V.E. Additionally, the employees developing IP within SDG&E will follow the Rules as it pertains to anti-conduit activities consistent with training, processes, and compliance already established at SDG&E.

¹⁵ Rule IV.G states that "A utility shall maintain a record of all contracts and related bids for the provision of work, products or services between the utility and its affiliates for no less than a period of three years and longer if this Commission or another government agency so requires."

1 treatment toward the NewCo Sub. SDG&E will include a report from the Independent Evaluator
2 in any subsequent 851 filings.

3 **IV. PROPOSED SHARING MECHANISM**

4 If SDG&E and the NewCo Sub enter into a contract for IP rights, then the NewCo Sub
5 will pay SDG&E some form of financial compensation for the IP. The compensation could take
6 different forms, such as royalty fees (in the event of a license) or a one-time payment (in the
7 event of a sale). The specific compensation amount will be negotiated by the two entities, and
8 will vary depending on the specific IP, SDG&E's estimation of the IP's market value, and the
9 NewCo Sub's offer.

10 SDG&E proposes to implement a standard sharing mechanism to govern how any
11 financial compensation received by SDG&E from the NewCo Sub for IP rights is shared
12 between ratepayers and shareholders. Specifically, SDG&E proposes that its ratepayers receive
13 75% of the financial compensation SDG&E receives from the NewCo Sub for the IP rights and
14 shareholders receive 25% of the amount.¹⁶

15 This sharing mechanism is identical with the sharing mechanism approved by the
16 Commission in prior proceedings. In the last SDG&E General Rate Case ("GRC") decision to
17 examine this issue of sharing mechanisms for IP – the TY2012 GRC –the Commission held that
18 the 75/25 sharing mechanism would govern how revenues would be shared from any IP
19 developed as part of research, development, and demonstration ("RD&D") programs using
20 ratepayer funds.¹⁷ The Commission stated that this sharing mechanism was reasonable because

¹⁶ Note that the portion of financial compensation provided to SDG&E shareholders may be subject to corporate tax.

¹⁷ D.13-05-010 at 600 stated, "... to provide an incentive to SDG&E to seek out investments which may benefit both ratepayers and shareholders, we adopt a modified version of SDG&E's 60 (ratepayer) /

1 it was equitable to ratepayers while providing an incentive to SDG&E to commercialize the IP.¹⁸
2 Later the Commission adopted the same 75/25 sharing mechanism to govern how "financial
3 benefits of IP", like royalties and license fees, would be shared for RD&D resulting from the
4 EPIC program. In that decision, the Commission stated that "[t]he 75 percent/25 percent
5 allocation between ratepayers and shareholders is a fair and reasonable allocation . . . because it
6 maximizes the value of ratepayers' investment while recognizing the IOUs' successful effort . . .
7 ultimately to develop beneficial IP."¹⁹

8 SDG&E believes that the same motivations are present now – the Commission wants a
9 sharing mechanism that is equitable to ratepayers while providing an incentive to SDG&E to
10 pursue the commercialization of beneficial IP. Therefore, SDG&E believes the proposed
11 revenue sharing mechanism of 75/25 is reasonable.²⁰

12 **V. FRAMEWORK FOR FUTURE IP TRANSFERS UNDER SECTION 851**

13 All IP transactions between SDG&E and the NewCo Sub will be submitted to the
14 Commission for approval pursuant to Section 851. To simplify and expedite Commission review
15 of these future Section 851 filings, SDG&E proposes to standardize the information it provides
16 in Section 851 filings between SDG&E and the NewCo Sub for IP rights. Specifically, in these
17 future filings, SDG&E will:

40 (shareholder) sharing mechanism proposal for this GRC rate cycle. Instead of 60%, ratepayers should receive 75%, and shareholders should receive 25%.”

¹⁸ *Id.* (“This sharing is equitable in that it will reward ratepayers for providing all of the funds for the venture, while providing an incentive to SDG&E to market such a venture.”).

¹⁹ D.13-11-025 at 82-83; *see also id.* at Ordering Paragraph 34.

²⁰ This proposed sharing mechanism would not apply retroactively to any financial compensation received under already Commission-approved agreements and would not create a precedential sharing mechanism for any future agreements between SDG&E and non-affiliated third parties.

- 1 • Include a report from an Independent Evaluator that documents the
2 evaluation, negotiation and selection process;
- 3 • Demonstrate that SDG&E selected the offer that provides a potential
4 optimal result for SDG&E and its ratepayers; and
- 5 • Commit to the standardized sharing mechanism of 75% (ratepayers) / 25%
6 (shareholders) for any financial compensation received by SDG&E from
7 the NewCo Sub for the IP rights.

8 By including this standard information in each Section 851 filing for IP licensed to the
9 NewCo Sub, SDG&E hopes to simplify and expedite future Commission Section 851 reviews.

10 **VI. ILLUSTRATIVE EXAMPLE: CONTRACT TO COMMERCIALIZE THE**
11 **RENEWABLE METER ADAPTER**

12 To illustrate the process above with an example, consider how the Renewable Meter
13 Adapter (“RMA”) IP might be treated if SDG&E’s requests for waivers is granted by the
14 Commission and the NewCo Sub.

15 SDG&E serves residential customers who purchase or lease rooftop solar, electric
16 vehicles, and distributed energy resources. Some of these customers live in homes older than
17 1995 who may face additional costs and delays to install solar because their older homes require
18 an electrical panel upgrade to support rooftop solar. SDG&E invented and developed the RMA
19 to simplify the interconnection process for these older homes. At its most basic level, the RMA
20 is an alternative to the electrical panel upgrade needed by some residential customers installing
21 new rooftop solar photovoltaic systems. The RMA can be adapted to other applications, such as
22 electric vehicles and distributed energy resources. SDG&E has submitted multiple applications
23 for patents to the U.S. Patent and Trademark Office for the RMA.

1 Currently, the RMA is available only in SDG&E’s service territory under a Rule 2
2 Special Facilities contract. The RMA is not available outside of SDG&E’s service territory.²¹
3 SDG&E believes that by making the RMA available in all areas (not just SDG&E’s service
4 territory), rooftop solar will become more affordable for more residential customers. In turn, this
5 will further the State’s goals of increasing the supply and use of renewable energy. If SDG&E
6 can license the RMA IP to one (or more) third parties, then SDG&E ratepayers would begin
7 receiving financial compensation for the IP.

8 If SDG&E’s requests for waivers is granted, SDG&E might pursue commercializing the
9 RMA through an agreement with NewCo Sub. NewCo Sub would evaluate the business
10 opportunity to manufacture and distribute the RMA in California and across the country, and
11 make an offer to SDG&E for the RMA IP rights. SDG&E would evaluate the NewCo Sub’s
12 offer, and any other offer received from a third party, to decide whether to enter contract
13 negotiations with one (or more) of the offerors. In this hypothetical scenario, SDG&E would
14 retain an Independent Evaluator to observe and review the interactions and any negotiations
15 between SDG&E and the NewCo Sub with regards to the RMA. SDG&E would seek
16 Commission approval pursuant to Section 851 for any resulting agreements; if the NewCo Sub
17 was involved in the process, SDG&E would attach the Independent Evaluator’s report to the 851
18 filing. Assuming Commission approval is received, SDG&E ratepayers would receive 75% of
19 the agreed-upon amount that the NewCo Sub would pay SDG&E for the RMA IP rights.

²¹ SDG&E Advice Letter 2982-E (submitted October 5, 2016; currently pending). SDG&E signed term sheets with a manufacturer and a distributor for three-year non-exclusive licenses to the RMA. SDG&E submitted the Section 851 Advice Letter with the Commission seeking Commission approval of the license agreements contingent on the parties executing contracts. Since SDG&E filed AL 2982-E, the distributor has failed to complete the distribution agreement. Therefore, SDG&E is actively pursuing additional offers from third parties to manufacture and distribute the RMA to solar customers who are not in SDG&E’s service territory.

1 **VII. CONCLUSION**

2 SDG&E’s Proposal to create the NewCo Sub is designed to help commercialize SDG&E
3 IP and generate value for SDG&E ratepayers. By making the IP more widely available in the
4 market, this Proposal may advance the Commission’s safety, reliability, efficiency and
5 environmental objectives across California and the country. SDG&E intends to engage in
6 competitive solicitations from third parties, including the NewCo Sub, for agreements on access
7 to IP rights. This is designed to not hinder market competition and instead, to garner potential
8 financial opportunities for its ratepayers. By retaining an Independent Evaluator and providing
9 an Independent Evaluator’s Report, as well as standardizing the sharing mechanism of any
10 financial compensation received by SDG&E from the NewCo Sub for the IP rights, SDG&E
11 hopes to increase transparency in the process and facilitate Commission review of any resulting
12 agreements between SDG&E and the NewCo Sub.

1 **WITNESS QUALIFICATIONS**

2 My name is Stephen Johnston, and my business address is 8316 Century Park, CP52F,
3 San Diego, California 92123.

4 In August 2016, I was made Growth Development Manager for SDG&E. In that role, I
5 am responsible for identifying and pursuing non-traditional growth opportunities, including
6 opportunities involving intellectual property.

7 I have held various positions within SDG&E since 2012, including Team Lead with the
8 Customer Generation group which introduced the Renewable Meter Adapter for SDG&E
9 customers.

10 I received a bachelor's degree in physics from Rochester Institute of Technology and a
11 master's degree in Physics from the University of Akron. I received a master's degree in
12 business administration from London Business School.

13 Prior to joining SDG&E, I was a product manager within the high tech and
14 semiconductor industries. I received an honorable discharge from the United States Marine
15 Corps Reserve.

16 I have not testified previously before the Commission.