D.T.E. 03-36

Petition of Bay State Gas Company for the recovery of exogenous costs associated with lost base revenues for the period September 1, 2001 to August 31, 2002.

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I. INTRODUCTION

On March 21, 2003, Bay State Gas Company ("Bay State" or "Company") filed a petition with the Department of Telecommunications and Energy ("Department") for authority to recover exogenous costs associated with lost base revenues ("LBR") of $1,413,872 as well as associated carrying costs of $48,312 attributable to installation of demand-side management ("DSM") programs for the twelve-month period ending August 31, 2002. The petition was docketed as D.T.E. 03-36. The Company seeks to recover LBR as an exogenous cost adjustment in accordance with the standard established by the Department in Colonial Gas Company, D.T.E. 00-73 (2001).

Pursuant to notice duly issued, the Department held a public hearing on May 6, 2003. At the public hearing, the Department granted intervenor status to the Division of Energy Resources ("DOER") and granted limited participant status to the Berkshire Gas Company, New England Gas Company, and Fitchburg Gas and Electric Light Company. The Department held an evidentiary hearing on September 9, 2003. At the evidentiary hearing, Bay State sponsored the testimony of Steven Bryant, vice-president of external affairs for the Company, and James Harrison, principal of Management Applications Consulting, Inc. The evidentiary record consists of the Company's initial filing, testimony, responses to 25 information requests, and ten record requests. No party other than Bay State presented evidence or witnesses at the hearing. On September 23, 2003, the Company filed a brief.

II. LBR RECOVERY

A. Company Proposal

Bay State seeks to recover $1,413,872 in lost base revenues as an exogenous cost from its DSM programs for the twelve-month period ending August 31, 2002 (Exhs. BSG-1, at 11; DTE 1-10). The Company indicates the exogenous costs it incurred are the result of the Department's adoption of the Rolling Period Method ("RPM") to calculate LBR (Exh. BSG-2, at 7). The Company states that of the $1,413,872 it is seeking to recover $575,653 is from residential heating DSM measures, $49,639 from residential non-heating measures, $300,315 from multi-family measures, and $488,265 from Commercial and Industrial ("C&I") measures (Exhs. BSG-1, at 12; DTE 1-10). The Company proposes to recover this amount through the exogenous cost factor in its Local Distribution Adjustment Clause ("LDAC") effective May 1, 2003 (Exh. BSG-1, at 12).[1]

Bay State indicates that from 1996 to 1999 the Company calculated the LBR associated with its DSM programs based on the cumulative therm savings for all DSM measures installed since the inception of the Company's DSM programs in 1993 through to the most recent year of installations (Exh. BSG-3, at 4-7). Beginning in 2000, the Company changed to the 4-year RPM that was approved by the Department in Colonial Gas Company, D.T.E. 97-112 (1999) to calculate the LBR (id. at 6). The RPM used the Company's cumulative therm savings for

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[1] The Department notes that the Company's local distribution adjustment factor ("LDAF") approved on October 31, 2003 included the exogenous costs proposed for recovery in this proceeding.

DSM measures installed over the last four years to calculate the LBR for a given year (id. at 4-8).

To calculate the LBR for the monthly therm savings for each type of DSM measure installed, the Company used engineering benchmarks and energy audits performed by its energy auditing vendors (Exh. BSG-3, at 8). Next, the Company calculated gross annual therm savings that were aggregated by measure type, by rate class, and by month of installation (id. at 8-9). Bay State reduced the gross annual therm savings by the measure-specific realization rates to calculate the net annual therm savings (id. at 9). The realization rates showed the relationship between the gross therm savings and those actually realized, based on a sample of the installed measures (id.).

The Company states that the annual therm savings for heating measures were divided by annual normal effective degree days ("EDD") (Exh. BSG-3 at 9).[2] The resulting per EDD unit savings were then multiplied by the actual observed monthly EDDs to develop monthly actual therm savings (id.). For non-heating measures, the annual therm savings were divided by twelve to determine the monthly therm savings (id.). To calculate the monthly LBR for each measure, the Company multiplied the total monthly therm savings by the weighted average incremental net revenue rates by rate class for that month (id. at 9-10). The measure-specific LBR for each month were added together to obtain the total LBR for the month (id. at

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[2] A degree day is a measure of the cold weather experienced, based on the extent to which the daily mean temperature falls below a reference temperature, usually 65 degrees Fahrenheit, without taking into account the wind speed. An effective degree day ("EDD") takes into account the wind speed in determining the coldness of the weather.

10). Bay State applied the pre-tax cost of capital of 10.25 percent that was approved by the Department in the Company's last rate case to the unrecovered average monthly LBR balances in order to compute the carrying costs on the balances (id. at 10; Tr. at 20).

Bay State indicates that for the twelve-month period ending February 28, 2002, the total net therm savings for all DSM measures using the RPM was 6,475,593 therms (Exh. DTE 1-11). For residential heating DSM measures, the total net therm savings was 1,685,053 therms (id.). The total net therm savings for residential non-heating measures was 27,336 therms (id.). The corresponding net therm savings for the multi-family and C & I measures was 1,240,985 therms and 3,522,219 therms, respectively (id.). Based on the net therm savings using the RPM, Bay State determined that for the twelve-month period ending August 31, 2002,[3] the total LBR for all measures installed as part of the Company's DSM programs was $1,163,345, with carrying costs of $130,802 (Exh. DTE 1-10). For the residential heating measures, the LBR was $441,926, with carrying costs of $46,398 (id.). For residential non-heating measures, the LBR was $8,753, with carrying costs of $857 (id.). For the multi-family and C&I measures, the LBRs were $171,936 and $540,730, respectively, with associated carrying costs of $19,264 and $64,283 (id.).[4]

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[3] According to Bay State, the Company installed additional measures between February 28, 2002 and August 31, 2002, but did not include the therm savings from these measures in the calculation of the LBR for this filing because the data were not included in its database (id. at 32-33). Bay State indicates that when the Company updates its database in its next LBR filing, it will include the therm savings from these additional measures in the calculation of the LBR "as a reconciling adjustment" (id.).

[4] Bay State indicates that the method that it used to compute the therm savings and LBR by measure and customer class has been used by the Company for many years and has been approved by the Department (Company Brief at 20-28, citing Exh. DTE 1-3,

Bay State indicates that beginning in 2000, the Company no longer recovered the total LBR attributed to all of its DSM programs because the RPM restricts the recovery of LBR to those measures installed within the last four years (Exh. BSG-3, at 12). The Company states that, based on the method which was in effect before the RPM was implemented in 2000, the total net therm savings for the twelve-month period ending February 28, 2002 was 16,415,852 therms (Exh. DTE 1-11). For residential heating DSM measures, the total net therm savings was 5,520,038 therms (id.). For residential non-heating measures, the total net therm savings was 162,963 therms (id.). The corresponding net therm savings for the multi-family and C & I measures were 3,503,593 therms and 7,229,259 therms, respectively (id.). Based on the net therm savings using the old method, Bay State determined that for the twelve-month period ending August 31, 2002, the total LBR for all measures installed since the inception of the Company's DSM programs was $2,577,217, with carrying costs of $179,114 (Exh. DTE 1-10). For the residential heating measures, the LBR was $1,017,580, with carrying cost of $66,768 (id.). For residential non-heating measures, the LBR was $58,391, with carrying costs of $2,333 (id.). And for the multi-family and C&I measures, the LBRs were $472,251 and $1,028,995, respectively (id.). The carrying costs for the multi-family and C&I measures were $29,343 and $80,670, respectively (id.).

The Company states that it calculated the exogenous cost of $1,413,872 as the difference between the total LBR under the prior method (i.e., $2,577,217) and the total LBR

Attachment DTE 1-3(a); Exh. DTE 1-3(b); Bay State Gas Company, D.P.U. 95-117 (1996); Bay State Gas Company, D.P.U. 96-98).

under the RPM (i.e., $1,163,345) (Exhs. BSG-3, at 13; DTE 1-10). Similarly, the Company calculated the associated carrying costs of $48,312 as the difference between the total carrying costs under the prior method (i.e., $179,114) and the total carrying costs under the RPM (i.e., $130,802) (Exh. DTE 1-10).[5]

B. Position of the Company

Bay State contends that the change in the Department's policy which required the Company to implement the RPM in 2000 resulted in the rapid decline in LBR recovery (Exh. BSG-3, at 7). According to Bay State, had the RPM not been implemented, the Company would have continued to recover cumulative LBR dating back to the inception of its DSM programs until its next base rate proceeding when it would adjust its rates to account for the DSM programs (id.; Company Brief at 6).

The Company argues that the decline in its LBR recovery stemmed solely from the use of the RPM, and that the change in regulatory policy was unexpected and beyond its control (Exh. BSG-3, at 7; Company Brief at 8-9). Bay State contends that it has satisfied the Department's standards for the recovery of exogenous costs because "[t]he costs at issue were caused by a change in regulatory policy uniquely affecting the local gas distribution industry that was external to the Company and beyond its control, and which would have a substantial effect on the Company's operations. [Furthermore], [t]he costs are known and measurable,

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[5] Bay State notes that it used the same method to calculate the exogenous costs and carrying costs as the method approved by the Department in recent proceedings (Company Brief at 20, citing Colonial Gas Company, D.T.E. 00-73 at 15, 22 (2001); Colonial Gas Company, D.T.E. 01-73 at 14-19 (2002), Colonial Gas Company, D.T.E. 02-58 at 13-17 (2003)).

and Bay State's earnings, independent of recovering a proposed exogenous cost, are significantly below its allowed rate of return." (Exh. BSG-2, at 5-6; Company Brief at 6-29, citing Bay State Gas Company, D.P.U. 96-98 (1997); Colonial Gas Company, (NOI), D.T.E. 97-112 (1998); Colonial Gas Company, D.T.E. 00-73 (2001); Colonial Gas Company, D.T.E. 01-73 (2002); Colonial Gas Company, D.T.E. 02-58 (2003); Eastern-Essex Acquisition, D.T.E 98-27, at 19 (1998); Eastern-Colonial Acquisition, D.T.E. 98-128 (1999); NIPSCO-Bay State Acquisition, D.T.E. 98-31, at 17 (1998)).

The Company states that the Department has established a monetary threshold for exogenous cost recovery for Bay State of $500,000 (Company Brief at 18, citing NIPSCO-Bay State Acquisition, at 18). Bay State argues that the cost impact of the change in Department regulatory policy of $1,423,872 for which it seeks an exogenous cost adjustment exceeds the Department-established threshold, and therefore, is sufficient to have a substantial effect on the Company's operations (id. at 18-19, citing Exhs. BSG-1 at 3; BSG-2 at 11; D.T.E. 1-23).[6]

Bay State argues that the Company's return on equity ("ROE") in 2002 was 7.76 percent which is significantly lower than the ROEs granted by the Department in the most recently litigated base rate cases for gas distribution companies in Massachusetts, and the 11.4 percent ROE granted by the Department in the Company's last base rate proceeding (Company Brief at 29, citing Exh. DTE 1-16; RR-DTE-1; RR-DTE-2; Tr. at 16-17).[7] Specifically,

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[6] Bay State contends that the Company is not required to let its operations actually deteriorate before being able to recover exogenous costs (Company Brief at 18, citing Colonial Gas Company, D.T.E. 00-73 at 21 (2001)).

[7] Bay State notes that the Department approved an ROE of 10.5 percent for Berkshire Gas Company, and 10.0 percent for Fitchburg Gas and Electric Light Company in

according to Bay State, even if the Company included the requested $1.4 million in LBR in the ROE calculation for 2002, the ROE would have been 8.18 percent, which is still significantly lower than the Company's allowed ROE and the ROE granted to local distribution companies ("LDCs") in the most recently litigated base rate cases (Company Brief at 29, citing Exh. DTE 1-21; RR-DTE-9). Similarly, Bay State argues that even if the Company's average earned ROE for the period 1995-2001 of 7.65 percent is used, it is still significantly lower than the Company's allowed ROE of 11.4 percent and the ROE granted in the most recently litigated base rate proceedings (Company Brief at 28, citing RR-DTE-9).

Bay State contends that the record in this proceeding amply demonstrates that the Company's request for recovery of LBR in the amount of $1,413,872 meets the Department standard for exogenous cost recovery (Company Brief at 30). The Company argues that the Department has approved three filings that were submitted by Colonial Gas Company in recent proceedings in which identical issues of fact and law were presented (id. citing, D.T.E. 97-112; D.T.E. 00-73; D.T.E. 01-73). Bay State, therefore, requests that the Department approve the Company's recovery of LBR as an exogenous cost adjustment in the amount of $1,413,872 for the period September 1, 2001 through August 31, 2002 (id.).

C. Standard of Review for Savings Estimates

In evaluating savings estimates for gas DSM programs, the Department considers its experience with electric DSM programs. See Bay State Gas Company, D.P.U. 96-98, at 1

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recent base rate proceedings (Company Brief at 29, citing RR-DTE-2, Berkshire Gas Company, D.T.E. 01-56 (2002), Fitchburg Gas and Electric Light Company, D.T.E. 02-24/25 (2002)).

(1997). The Department has found that many estimates of savings that are not actually measured have been biased upward substantially, and has therefore required companies to measure savings using impact evaluations. Massachusetts Electric Company, D.P.U. 92-217-B, at 4-5 (1994) ("MECO"). The Department has identified and approved a wide variety of techniques for evaluating savings estimates. See id. at 7-16, 35-38, 47-51, 68-74. Recognizing that obtaining more precise savings estimates has a cost, the Department directed companies to seek increased precision to the extent that the marginal value of more precise estimates exceeds the marginal cost of obtaining the additional precision. MECo at 5.

In MECo, the Department introduced a standard of review to be applied to impact evaluations[8] and has used this standard for gas DSM evaluations (i.e., a company must demonstrate that its impact evaluations are reviewable, appropriate, and reliable). D.P.U. 96-98, at 2, citing MECo at 4-6. An impact evaluation is considered reviewable if it is complete, clearly presented, and contains a summary that sufficiently explains all assumptions and data presented. MECo at 4-6. An impact evaluation is considered appropriate if evaluation techniques selected are reasonable given the characteristics of a particular DSM program, the company's resources, and the available methods for determining demand and energy savings estimates. Id. Finally, an impact evaluation is considered reliable if the savings estimates included in the evaluation are unbiased and are measured to a sufficient level of precision, given the characteristics of a particular DSM program, the company's resources, and the available methods for determining demand and energy savings estimates. Id.

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[8] Impact evaluations use quantitative analyses to assess energy and capacity savings resulting from the implementation of DSM programs. MECo at 1.

In Boston Gas Company, D.P.U. 94-15 (1995), the Department ordered LDCs, when petitioning for the recovery of LBR and incentives from DSM programs, to develop energy savings estimates for their residential and multifamily programs using the Gas Evaluation and Monitoring Study ("GEMS")[9] method,[10] subject to certain conditions. See D.P.U. 94-15, at 52-54.

D. Analysis and Findings on Saving Estimates

The Department has reviewed Bay State's impact evaluations. The Company provided a detailed explanation of how it calculated savings estimates, with supporting data (Exh. BSG-1, scheds. B-K). The evidence has established that the impact evaluations are complete and clearly presented, with all data and assumptions sufficiently explained (id.). Accordingly, the Department finds that the Company's impact evaluations are reviewable.

As described above, in its evaluation, the Company has used engineering benchmarks and energy audits to calculate energy savings. The Department has approved the use of engineering benchmarks and energy audits as being appropriate methods for determining energy savings for the types of programs that are being implemented by the Company. See Colonial Gas Company, D.T.E. 00-73 (2001); Colonial Gas Company, D.T.E. 01-73 (2002).

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[9] GEMS was a comprehensive research project which used a variety of analytical tools to evaluate the effectiveness of residential and multi-family natural gas DSM programs. D.P.U. 94-15, at 1 n.1.

[10] GEMS method refers to the overall analytical framework established by Boston Gas Company to: (1) determine the effectiveness of Boston Gas Company's residential DSM programs by estimating the amount of gross energy saved from a sample of its residential customers; (2) transfer these results to its residential DSM and non-host local distribution companies' DSM programs; and (3) adjust gross savings to account for factors that affect net program savings. Id., at 1 n.2.

Accordingly, the Department finds that the impact evaluations filed by the Company are appropriate.

As stated above, an impact evaluation is considered reliable if the energy savings estimates that are included in the evaluation are sufficiently unbiased and are measured to a sufficient level of precision. The Department observes that the application of measure-specific realization rates to the gross therm savings that were used to calculate the net therm savings, and the weather "normalization" of the annual therm savings for the heating measures both produced energy savings estimates of sufficient level of precision. Accordingly, the Department finds that the impact evaluations filed by the Company are reliable. Having found that Bay State's impact evaluation savings estimates are reviewable, appropriate and reliable, we accept them.[11]

E. Standard of Review for Exogenous Cost Recovery

The Department evaluates the Company's ability to recover LBR through an exogenous cost adjustment in part based on its determinations concerning the requirements for exogenous cost recovery. See Eastern-Colonial Acquisition, D.T.E. 98-128 (1999); NIPSCO-Bay State Acquisition, D.T.E. 98-31 (1998); Eastern-Essex Acquisition, D.T.E. 98-27 (1998); Boston Gas Company, D.P.U. 96-50 (Phase I) (1996).

Specifically, the Department has defined exogenous costs as positive or negative cost changes beyond a company's control that would significantly affect the company's operations.

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[11] The Department notes that Bay State will include the therm savings from the additional measures that the Company installed between February 28, 2002 and August 31, 2002, (not included in the calculation of the LBR for this filing) as a reconciling adjustment in the Company's next LBR filing.

Eastern-Colonial Acquisition at 54; NIPSCO-Bay State Acquisition at 17; Eastern-Essex Acquisition at 19. Included in that definition are cost changes resulting from: changes in tax laws that uniquely affect the local gas distribution industry; accounting changes unique to the local gas distribution industry; and regulatory, judicial or legislative changes uniquely affecting the local gas distribution industry. Boston Gas Company, D.P.U.96-50 (Phase I) at 292; NIPSCO-Bay State Acquisition at 17; Eastern-Essex Acquisition at 19. In the Eastern-Colonial Acquisition at 55, the Department recognized that a change in our regulatory policy, including our LBR policy, that had cost consequences, would be encompassed under our definition of an exogenous cost.

In that case, the Department also noted its concern about the cost to adjudicate LBR recovery. Id. In fact, to avoid costly regulatory process over minimal dollars, the Department has stated that cost changes must meet a monetary threshold, based on a company's size, for qualification to be proposed as an exogenous cost. Id. See also, NIPSCO-Bay State Acquisition at 18; Boston Gas Company, D.P.U. 96-50 (Phase I) at 293. The Department established thresholds on a company-specific basis to reflect a "principle of proportionality" in relation to the company's operating revenues. Eastern-Colonial Acquisition at 55-56. To that end, the Department determined that any individual exogenous cost must exceed the Company's threshold in a particular year before a company can request recovery of that particular exogenous cost increase. Id. at 55-56; NIPSCO-Bay State Acquisition at 18; D.P.U. 96-50 (Phase I) at 293. To recover exogenous costs during a rate plan, Petitioners are required to propose exogenous cost adjustments, with supporting documentation and rationale,

to the Department for determination as to the appropriateness of recovery of the proposed exogenous costs. Eastern-Colonial Acquisition at 55; NIPSCO-Bay State Acquisition at 17-18.

The Department also has indicated that for rate plans approved pursuant to the merger filings that are not performance based regulation ("PBR") plans, there will be no change to the traditional cost of service regulation by which the Department currently regulates the rates of the companies. Eastern-Essex Acquisition at 16. Accordingly, during the duration of each rate plan, the earnings of the companies will be a factor in consideration of whether the Department will approve a request for recovery of an exogenous cost. D.T.E. 00-73, at 21. Proponents of an exogenous cost adjustment bear the burden of demonstrating: (1) that the cost change is of a type that is external to the company and is "beyond the company's control"; (2) that the magnitude of the cost change is such so as to significantly affect the company's operations; and (3) that the company's earnings, independent of recovering a proposed exogenous cost, are reasonable. Id.

F. Analysis and Findings on Exogenous Cost Recovery

As stated above, Bay State seeks to recover $1,413,872 in LBR (plus carrying costs of $48,312) as an exogenous cost adjustment. This amount represents the annual impact of the Department's change in regulatory policy that was established in D.T.E. 97-112.[12] The Department acknowledges that a change in the Department's regulatory policy, including LBR

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[12] In D.T.E. 97-112, at 32-33, the Department modified the allowed recovery period of LBR to the average amount of time elapsed between each of the petitioning company's four most recent rate cases. Before D.T.E. 97-112, the Department allowed recovery of LBR over the life of each DSM measure. See Colonial Gas Company, D.P.U. 96-31 (1996).

policy, that has cost consequences, is encompassed under the definition of an exogenous cost. D.T.E. 98-128, at 55. In Bay State's case, the Department established a monetary threshold of $500,000. NIPSCO-Bay State Acquisition at 18. The record in this case shows that the cost impact of the change in regulatory policy is $1,413,872, which exceeds the threshold established by the Department in the Merger Order. Therefore, the Department finds that the Company has met the Department's first two conditions for the proposed recovery of exogenous costs. That is, the cost change is of a type that is external to the Company, and the magnitude of the cost change exceeds the established monetary threshold.

The question remains as to whether the Company's earnings were such as to warrant recovery of the $1,413,872 in exogenous costs. The record shows that the Company's 2002 ROE was 7.76 percent (Exh. DTE 1-16). This return is lower than the ROE allowed by the Department for Bay State and other LDCs in the most recently litigated rate cases. See Keyspan Energy Delivery d/b/a Boston Gas , D.T.E. 03-40, at 364 (2003); Berkshire Gas Company, D.T.E. 01- 56, at 119 (2002); Fitchburg Gas and Electric Light Company, D.T.E. 02-24/25, at 230 (2002). If Bay State were allowed to recover the $1,413,872 as an exogenous cost, the Company's ROE would increase from just 7.76 percent to 8.18 percent (Exh. DTE 1-21). That Bay State's current return is lower than the ROE allowed by the Department for Bay State in establishing just and reasonable rates for that company is prima facie evidence that the third prong of the Colonial Gas Company, D.T.E. 00-73, test for exogenous cost recovery has been met. That Bay State's current ROE is also lower than those recently set for other LDCs is important corroboration of reasonableness and strengthens the case for allowance. The Department concludes that the level of Bay State's earnings for 2002

warrants approval of the Company's petition for recovery of the $1,413,872 in LBR. Therefore, the Department finds that Bay State has met the third condition of the Department's three-pronged test for proposed recovery of exogenous costs. Accordingly, the Department will allow for the recovery of the LBR as an exogenous cost in this case.

III. ORDER

Accordingly, after due notice, hearing and consideration, it is

ORDERED: That the savings estimates for Bay State Gas Company's DSM measure installations for the period September 1, 2001 through August 31, 2002 are hereby approved; and it is

FURTHER ORDERED: That the Company shall recover total lost base revenues of $1,413,872 and total carrying costs of $48,312 as exogenous costs associated with its demand-side management programs for the period September 1, 2001 through August 31, 2002.

By Order of the Department,

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Paul G. Afonso, Chairman

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James Connelly, Commissioner

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W. Robert Keating, Commissioner

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Eugene J. Sullivan, Jr., Commissioner

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Deirdre K. Manning, Commissioner

Appeal as to matters of law from any final decision, order or ruling of the Commission may be taken to the Supreme Judicial Court by an aggrieved party in interest by the filing of a written petition praying that the Order of the Commission be modified or set aside in whole or in part.

Such petition for appeal shall be filed with the Secretary of the Commission within twenty days after the date of service of the decision, order or ruling of the Commission, or within such further time as the Commission may allow upon request filed prior to the expiration of twenty days after the date of service of said decision, order or ruling. Within ten days after such petition has been filed, the appealing party shall enter the appeal in the Supreme Judicial Court sitting in Suffolk County by filing a copy thereof with the Clerk of said Court. (Sec. 5, Chapter 25, G.L. Ter. Ed., as most recently amended by Chapter 485 of the Acts of 1971).