The Commonwealth of Massachusetts

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

D.T.E. 03-89 February 18, 2004

Petition of The Berkshire Gas Company for approval of the issuance from time to time of long-term debt securities in an amount not to exceed $20,000,000.

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I. INTRODUCTION

On September 15, 2003, The Berkshire Gas Company ("Berkshire" or "Company") filed a petition with the Department of Telecommunications and Energy ("Department") pursuant to G.L. c. 164, § 14, requesting approval of a financing plan for the issuance and sale from time to time of up to $20,000,000 of long-term debt securities. Under its financing plan, Berkshire also would seek to use derivative instruments[1] to manage interest rate risk to lock in a rate before the issuance date of its long-term debt securities. The Company also seeks exemptions from the competitive bidding requirements of G.L. c. 164, § 15, and the par value provisions of G.L. c. 164, § 15A.

Pursuant to notice duly issued, a public hearing was held at the Department's offices in Boston on December 3, 1002. The Attorney General of the Commonwealth ("Attorney General") filed a notice of intervention pursuant to G.L. c. 12, § 11E. At the hearing, the Company presented one witness in support of its petition: Karen Zink, vice president and general manager of Berkshire. The evidentiary record consists of 37 exhibits and four responses to record requests issued by the Department. The Attorney General filed a brief on December 11, 2003. The Company filed a brief on December 16, 2003.

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[1] A derivative is a financial instrument that derives its value from the value of an underlying asset, reference rate, or index. In this case, an interest rate lock is a derivative because it derives its value from an interest rate index. Derivative instruments and hedging arrangements are governed by the Statement of Financial Accounting Standards No. 133.

II. DESCRIPTION OF THE COMPANY'S PROPOSAL

Berkshire seeks authorization for the issuance and sale, from time to time on or prior to January 31, 2007, of long-term debt securities in an aggregate amount (based on face amount) of $20,000,000 (Exh. BG-1, at 3). Berkshire's issuance of long-term debt instruments may consist of: (i) unsecured notes, (ii) first mortgage bonds, or (iii) term loans (id. at 6). The Company states that the long-term debt issuances will have a maturity date greater than one year but not later than 40 years from the date of issuance (id. at 10). Berkshire proposes that the long-term debt securities would carry either a fixed interest rate not to exceed an effective rate of twelve percent per annum, or an adjustable rate that would vary with a market index designated at the time of issue or in accordance with a market auction mechanism, but which will not exceed eighteen percent per annum (id. at 8; Tr. at 10). The Company states that it has proposed the maximum interest rates based on historical interest rate environments, and that these levels afford the Company maximum flexibility (Exh. DTE-1-11). The adjustable rate securities would be priced based upon an established and published index plus some "spread" (Exh. DTE-1-12). The Company expects that any debt issued pursuant to its proposed financing plan will be priced off either the prime rate or the London Interbank Offered rate (referred to as LIBOR) (Exh. DTE-2-2).

Also, the Company's financing plan contemplates the use of interest rate hedging transactions, including treasury locks (id.). Berkshire states that this type of interest rate management would be an important means for the Company to manage interest rate risk

(id. at 17). Specifically, Berkshire might enter into a treasury lock with a counter party whereby, if interest rates increase prior to the planned debt issuance, Berkshire would be entitled to receive a payment based on the actual treasury rate and the "lock rate" (id. at 18). These types of transactions involve the selection of a specific treasury reference and a planned debt "issuance date" (id.). The issuance date also becomes the "settlement date" for the treasury lock transaction (id.). At the time of this transaction, the lock rate is based on the then-current treasury rate for the maturity being considered by the Company (id.). At the settlement date, which also would be the date at which Berkshire would issue a long-term debt security, a payment is made based on the difference between the lock rate and the treasury rate as of that date (id.). A payment would be made to Berkshire if rates increase from the transaction date. Conversely, Berkshire would make a comparable payment to the counter party if rates decrease (id.). Berkshire proposes to amortize the gain or loss from this transaction over the life of the debt security, with the effective reduction or increase in the cost of the debt (id.). The Company estimates that the fee for entering into a derivative transactions would be approximately two basis points (Tr. at 19).

Berkshire maintains that it will not employ these instruments for speculative purposes (Exh. BG-1 at 19). The Company maintains that it will execute such transactions only to lock in a lower rate (id.). According to Berkshire, it will execute rate lock transactions only with counter parties that have an unsecured senior debt rating (or with a parent entity with such a rating) of A or better as published by Standard and Poor's Rating Group (or an equivalent

rating from Moody's Investor Service) (id.). Berkshire states that it will execute interest rate lock transactions with a term of less than one year, most likely for a term of 60 days or less (id.; Tr. at 20-21).

The Company states that it will employ these instruments consistent with the Derivative Policy of Energy East Corporation ("Energy East") ("Derivative Policy"), Berkshire's parent company (Exh. BG-1, at 19). According to the Derivative Policy, Energy East and its subsidiaries will not enter into any speculative derivative transactions and the use of derivatives will be confined to risk management (Exh. BG-12). Only officers of Energy East Management Company can enter into and exit derivative transactions (id.). Each derivative transaction will require a written description of its strategic objective, business purpose, and exit strategy (id.). Energy East's treasurer's organization will establish credit limits for each counter party prior to any transaction (id.). All derivative activity will be reported to the Energy East audit committee (id.). The derivative transactions will not be leveraged (i.e., the principal amount of the derivatives will not exceed the underlying value of the assets hedged) (id.).

The Company's financing plan is proposed to extend through January 31, 2007, which coincides with the mid-period review of Berkshire's price cap mechanism plan[2] (Exhs. BG-1, at 3; DTE-1-14). The Company contends that the length of its proposed financing plan contributes to its flexibility, which can enable the Company to take advantage of favorable

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[2] On January 31, 2002, the Department issued an order approving a price cap mechanism for Berkshire with a ten-year term and a mid-term review after five years. The Berkshire Gas Company, D.T.E. 01-56, at 10-11 (2002).

market conditions (Exh BG-1, at 9). Berkshire maintains that being able to respond promptly to market conditions can result in minimizing capital costs (Exh. DTE-1-15).

The Company states that the net proceeds of the proposed financing plan will be used for: (a) the payment at maturity of certain outstanding long-term indebtedness and equity securities; (b) the payment of capital expenditures for additions to property, plant, and equipment, or for the payment of obligations of the Company incurred for such expenditures; (c) the refinancing of short-term and long-term securities; and (d) for general working capital purposes (Exh. BG-1, at 3; Tr. at 10).

Berkshire seeks an exemption from the competitive bidding requirements of G.L. c. 164, § 15 pertaining to the issuance of debt securities (Petition at 5; Exh. DTE 1-3). The Company states that the securities would be sold in one or more public offerings through one or more underwriters or agents, in private offerings, or in connection with the establishment of loan facilities with one or more institutional or government lenders (Exh. BG-1, at 11). The Company states that it prefers to use negotiated transactions for the issuance of debt securities rather than a competitive bid process because of the flexibility offered by negotiated transactions and in order to take advantage of the underwriters' expert knowledge in marketing securities (id. at 13). Berkshire maintains that the competitive bid process inhibits its ability to vary the form and timing of issuances, which is advantageous in today's complex, fluctuating and volatile financial markets (id. at 16). The Company considers that its request for an

exemption from the provisions of G.L. c. 164, § 15 is consistent with Department precedent, will benefit ratepayers, and is in the public interest (id. at 16).

The Company also seeks an exemption from the par value requirements of G.L. c. 164, § 15A (Petition at 5; Exh. DTE 1-1). The Company explained that its debt securities are generally issued with a coupon rate equal to either a multiple of one-eighth of one-percent or 0.05 percent (Exh. DTE 1-1). In contrast, financial markets price debt securities by reference to a comparable maturity United States treasury security, which would be priced in increments of 0.01 percent (id.). Therefore, Berkshire states that the face value of the security must often be discounted a very small amount to reflect the finer pricing of the security in the marketplace (id.).[3] The Company states that this pricing method is consistent with Department precedent and is in the public interest (id., citing Boston Edison Company, D.P.U. 92-253-A at 21 (1993); Eastern Edison Company, D.P.U. 93-24, at 5 (1993); Bay State Gas Company, D.P.U. 91-25, at 10 (1991)).

III. CAPITAL STRUCTURE

As of September 30, 2003, Berkshire's utility plant in service, including $62,858,000 in goodwill associated with the Company's acquisition by Energy East in 2002, was $194,661,000 (Exh. DTE 1-7; RR-DTE-1, Schs. KLZ-1, KLZ-5). After removing $48,594,000 in accumulated depreciation and $2,198,000 in amortized goodwill, the Company

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[3] Berkshire proposes to amortize any debt discount over the life of the corresponding debt issue on a straight-line basis (Exh. DTE 1-2).

reported a net utility plant of $143,869,000 (RR-DTE-1, Sch. KLZ-5). As of September 30, 2003, the Company reported a total capitalization of $145,462,250, consisting of (1) $40,000,000 in long-term debt, (2) $250,000 in preferred stock, (3) $250 in common stock, (4) $98,455,000 in paid-in capital, and $6,757,000 in retained earnings (id.; Exhs. BG-9; DTE 1-16).[4] The Company's paid-in capital balance included $62,858,000 in goodwill (Exh. BG-9; RR-DTE-1, Schs. KLZ-7, KLZ-7a).

Berkshire proposed a number of adjustments to these capitalization and net utility plant balances (Exh. BG-6). First, the Company increased its net plant in service by $5,512,000, consisting of $25,088,000 in total projected capital expenditures for the years 2003 through 2006, less $19,576,000 in cash expected to be generated by depreciation over that same period (Exhs. BG-1, at 7; BG-6; BG-7, at 1; RR-DTE-1, Sch. KLZ-5). Berkshire contends that its current net plant has been artificially constrained by an ongoing labor dispute that has affected routine construction activity (Exhs. BG-1, at 6; DTE 1-4; Company Brief at 4-5). The Company reasons that once the strike is resolved, a more normal level of construction activity can be expected to occur, thereby increasing the amount of plant available to support the proposed financing (Company Brief at 5). This adjustment results in a proposed net plant balance of $149,381,000 (RR-DTE-1, Sch. KLZ-5).

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[4] Because the data in Exhibit BG-2 is rounded to the nearest thousand dollars, the Company's outstanding common stock does not appear as a separate line item on the exhibit (Tr. at 13).

In recognition of this plant adjustment, the Company made several adjustments to its capitalization. First, the Company reduced its preferred stock by $20,000 representing a mandatory redemption offering to be made on September 15 of each year (Exhs. BG-6; DTE 1-16, at 6). Second, the Company reduced its long-term debt balance by $6,000,000 representing a medium-term note scheduled to mature in April 2004 (Exhs. BG-1, at 7; BG-6; BG-8; RR-DTE-1, Sch. KLZ-5). Third, the Company reduced its paid-in capital by $4,814,000 to account for the use of a portion of the Company's paid-in capital for non-utility property (Exh. DTE 1-5; RR-DTE-1, Sch. KLZ-5). Fourth, the Company eliminated from capitalization its retained earnings balance of $6,757,000 (id.). Finally, the Company included in its proposed capitalization $20,000,000 associated with the debt issuance proposed in this proceeding (Exh. BG-8; RR-DTE-1, Sch. KLZ-5).

As a result of these adjustments, the Company's total reported capitalization amounted to $147,871,250 (RR-DTE-1, Sch. KLZ-5). Therefore, Berkshire concluded that, after issuance of the proposed debt, the Company would have $1,509,750 more in plant than securities outstanding, thereby meeting the requirements of the net plant test (id.).

IV. POSITIONS OF THE PARTIES

A. Attorney General

1. Long-Term Debt

The Attorney General argues that the Department should reject the Company's financing request of $20,000,000 because the Company's fails to meet the net plant test

(Attorney General Brief at 1, 3). Instead, the Attorney General asserts, the Department should authorize the Company's issuance of up to $7.75 million in long-term debt, which is the amount that the Company's net utility plant exceeds its capitalization as of September 2003 (id. at 3, citing Exh. BG-6, Schedule KLZ-5, plus the Commercial Note due September 2003 in the amount of $4,707,400). The Attorney General maintains that if the Department approves any amount over $7.75 million, the Department should condition that approval on Berkshire's making contemporaneous filings showing that the additional financing meets the net plant test (Attorney General Brief at 3-4, citing Commonwealth Electric Company, D.T.E. 02-51, at 7-8 (2002); Boston Edison Company, D.T.E. 00-62, at 10-11 (2000); East Northfield Water Company, D.P.U./D.T.E. 97-36, at 6-7 (1997); Colonial Gas Company, D.P.U. 95-76, at 7-8 (1995)).

2. Authority to Enter Into Derivative Transactions

The Attorney General argues that the Department should deny the Company's request to trade financial derivatives (id. at 4). The Attorney General contends that the Company has not shown that its hedging proposal is "reasonably necessary" or that it would accomplish a "legitimate purpose" related to Berkshire's service obligations (id. at 5). He asserts that the Company's hedging proposal would harm ratepayers by increasing the investment risk profile of the Company while benefitting only shareholders (id.).

Also, the Attorney General argues that Berkshire's proposal to retain the gains and losses from derivatives trading sets up an inherent conflict between shareholder and customer

interests that would harm customers (id.). He contends that the gains and losses from the trading will depend on the interest rate associated with the Company's securities (id.). The Attorney General maintains that since the Company also will be negotiating the terms of the securities issues, including the maturity, interest rate, and fixed versus variable components, Berkshire no longer would have an incentive to negotiate the best terms for customers in the original instrument (id.). Instead, the Attorney General asserts, Berkshire would have an incentive to use the derivative securities to reverse the terms of the original instrument so that its shareholders will profit from the corrections (id.).

Further, the Attorney General argues that the Department should deny Berkshire's proposal to trade financial derivatives because the Company has not shown that it has appropriate internal controls or the necessary expertise to trade successfully (id. at 6). He claims that under the Derivative Policy, any management company employee of East Energy can perform the hedging activities for the Company (id. at 7). The Attorney General asserts that there are no requirements that employees be educated and licensed to perform financial derivatives trades (id.). He contends that inexperienced traders could cause severe financial harm to the Company (id.).

Finally, the Attorney General argues that the Company does not need to issue derivatives to lock in interest rates since the issues will be by private placements (id.). He contends that, with a little foresight and planning, the private placement should be accomplished in a relatively short time, given the extremely flexible nature of the financing

plan that the Company is requesting (id.). The Attorney General maintains that there should be no need to lock in interest rates for the brief period between when the Company believes, rightly or wrongly, that interest rates are optimal and when the issuance actually takes place (id. at 8). The Attorney General, thus, asserts that Berkshire's ability to issue private placements should obviate the need to lock in interest rates on the proposed debt issuances (id. at 8).

B. The Company

1. Long-Term Debt

The Company asserts that the Attorney General's argument regarding the net plant test does not reflect the correct calculation of the Company's currently available net plan (Company Brief at 4). Berkshire maintains that, as of September 30, 2003, it had $9,978,000 of excess net utility plant to total securities and debt (id., citing DTE-RR-1). The Company, thus, asserts, that the Department should find that this amount of additional long-term debt may be issued without any condition relating to compliance with the net plant test (id.). The Company further argues that it has demonstrated that as a result of a planned debt retirement and sinking fund payments during the term of the proposed financing plan and the expected resumption of its construction plan, the Company would have more than adequate net utility plant to support the full $20 million level of the proposed financing plan (id. at 4-5).

In the alternative, the Company states that it would be amenable to the Department authorizing Berkshire to issue long-term debt securities with conditions related to compliance

with the net plant test (id. at 5). As an initial matter, the Company contends that the record supports the Department approving issuance of up to $9,978,000 of long-term debt (id. at 5). In addition, the Company proposes that it be allowed to issue up to $6 million of long-term debt securities if either: (i) such issuance takes place after the retirement of the $6 million Medium Term Note due and payable on April 1, 2004 or (ii) the proceeds from the financing of such amount is used to retire such note (id.). The Company states that it would provide certification to the Department as to additional levels of net plant associated with preferred stock dividend payments and construction activities (id.). The Company maintains that this certification would demonstrate that additional net plant has become available or been added by the Company to support the financing (id.).

2. Authority to Enter Into Derivative Transactions

The Company argues that its proposed use of hedging instruments is reasonably necessary to enable the Company to manage market volatility and to seek to reduce costs for the benefit of the Company and its customers (Company Brief at 10). The Company agrees with the Attorney General that the use of private placements is an important means to manage floating rate risk (id. at 8). The Company asserts, however, that substantial market volatility risk remains even when a private placement is pursued (id.). Berkshire states that it typically takes more than one month, under the best of circumstances, to close a private placement, particularly if the Company seeks to implement some form of competitive process among

potential lenders (id.). Berkshire maintains that the use of private placement of debt securities alone would not enable the Company to manage floating risk to the same degree (id. at 9-10).

The Company takes exception to the Attorney General's suggestion that the use of hedging techniques will somehow create an incentive for the Company to negotiate inferior terms for the long-term debt issuances and then "gamble" seeking shareholder profit (id. at 10). Berkshire contends that the Attorney General is referring to speculative transactions and not hedging (id.). Berkshire asserts that the sort of speculation suggested by the Attorney General is not proposed by the Company and is not permissible under the Company's Derivative Policy (id.). The Company states that it is requesting authority only to engage in hedging transactions, i.e., transactions that lock in a level of interest rate (id. at 11). The Company further asserts that its management has no incentive other than to apply its best efforts to secure low-cost debt issuance given required accounting practices and the fact that the Company is now operating under a long-term, performance-based rate plan approved by the Department in D.T.E. 01-56 (id.).

Further, Berkshire argues that it has substantial expertise and controls for any hedging transactions (id.). Berkshire maintains that the Company and Energy East have substantial experience in closing a wide range of financial transactions, expertise that would be applied to the proposed financing plan (id. at 12). The Company states that the Derivative Policy establishes the following key controls: (i) only senior executives within the Energy East system may pursue the hedging transactions; (ii) a formal, written memorandum to the

Company's financial executives is required with respect to the overall business purpose and the planned exit strategy of the transaction; (iii) the treasurer's organization must review the hedging proposal and establish specific credit limits prior to the execution of each transaction; and (iv) reports of the transactions must be made to the treasurer's organization and to the audit committee of the board of directors (id.). The Company contends that the expertise to be applied to the hedging strategy is impressive and the internal controls are substantial and meaningful (id.).

V. STANDARD OF REVIEW

A. Long-Term Debt

In order for the Department to approve the issuance of stocks, bonds, coupon notes, or other types of long-term indebtedness[5] by an electric or gas company, the Department must determine that the proposed issuance meets two tests. First, the Department must assess whether the proposed issuance is reasonably necessary to accomplish some legitimate purpose in meeting a company's service obligations, pursuant to G.L. c. 164, § 14. Fitchburg Gas & Electric Light Company v. Department of Public Utilities, 395 Mass. 836, 842 (1985) ("Fitchburg II"), citing Fitchburg Gas & Electric Light Company v. Department of Public Utilities, 394 Mass. 671, 678 (1985) ("Fitchburg I"). Second, the Department must determine

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[5] Long-term refers to periods of more than one year after the date of issuance. G.L. c. 164, § 14.

whether the Company has met the net plant test.[6] Colonial Gas Company, D.P.U. 84-96 (1984).

The Supreme Judicial Court has found that, for the purposes of G.L. c. 164, § 14, "reasonably necessary" means "reasonably necessary for the accomplishment of some purpose having to do with the obligations of the company to the public and its ability to carry out those obligations with the greatest possible efficiency." Fitchburg II at 836, citing Lowell Gas Light Company v. Department of Public Utilities, 319 Mass. 46, 52 (1946). In cases where no issue has been raised about the reasonableness of management decisions regarding the requested financing, the Department limits its Section 14 review to a determination of reasonableness of the Company's proposed use of the proceeds of a securities issuance. Canal Electric Company, et al., D.P.U. 84-152, at 20 (1984); see, e.g., Colonial Gas Company, D.P.U. 90-50, at 6 (1990). The Fitchburg I and II and Lowell Gas cases also established that the burden of proving that an issuance is reasonably necessary rests with the company proposing the issuance, and that the Department's authority to review a proposed issuance "is not limited to a 'perfunctory review.'" Fitchburg I at 678; Fitchburg II at 841, citing Lowell Gas at 52. Regarding the net plant test, a company is required to present evidence that its net utility plant (original cost of capitalizable plant, less accumulated depreciation) equals or exceeds its total capitalization (the sum of its long-term debt and its preferred and common

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[6] The net plant test is derived from G.L. c. 164, § 16.

stock outstanding) and will continue to do so following the proposed issuance. Colonial Gas Company, D.P.U. 84-96, at 5 (1984).

Where issues concerning the prudence of the Company's capital financing have not been raised or adjudicated in a proceeding, the Department's decision in such a case does not represent a determination that any specific project is economically beneficial to a company or to its customers. In such circumstances, the Department's determination in its Order may not in any way be construed as ruling on the appropriate ratemaking treatment to be accorded any costs associated with the proposed financing. See, e.g., Boston Gas Company, D.P.U. 95-66, at 7 (1995).

B. Exemptions from G.L. c. 164, §§ 15, 15A

Pursuant to G.L. c. 164, § 15, an electric or gas company offering long-term bonds or notes in excess of $1,000,000 in face amount payable at periods of more than five years after the date thereof must invite purchase proposals through newspaper advertisements. The Department may grant an exemption from this advertising requirement if the Department finds that an exemption is in the public interest. G.L. c. 164, § 15. The Department has found it in the public interest to grant an exemption from the advertising requirement where there has been a measure of competition in private placement. See, e.g., Berkshire Gas Company, D.P.U. 89-12, at 11 (1989); Eastern Edison Company, D.P.U. 88-127, at 11-12 (1988); Western Massachusetts Electric Company, D.P.U. 88-32, at 5 (1988). The Department also has found that it is in the public interest to grant a company an exemption from the advertising

requirement when a measure of flexibility is necessary in order for a company to enter the bond market in a timely manner. See, e.g, Western Massachusetts Electric Company, D.P.U. 88-32, at 5 (1988). However, G.L. c. 164, § 15 requires advertising as the general rule, and waiver cannot be automatic, but must be justified whenever requested. Bay State Gas Company, D.T.E. 02-73, at 14 (2003).

Pursuant to G.L. c. 164, § 15A, a company is required to sell long-term bonds, debentures, notes, or other evidence of indebtedness at no less than the par value or face amount unless sale at less than par value is found by the Department to be in the public interest. See, e.g., Boston Edison Company, D.P.U. 91-47, at 13 (1991). The Department has found that it is in the public interest to grant an exemption from the par value requirement where market conditions make it difficult at times for a company to price a particular issue at par value and simultaneously offer an acceptable coupon rate to prospective buyers. Bay State Gas Company, D.P.U. 91-25, at 9 (1991). The Department also has found that it is in the public interest to authorize the issuance of debt securities below par value where this technique offers a company enhanced flexibility in entering the market quickly to take advantage of prevailing interest rates, particularly if this benefits the company's ratepayers in the form of lower interest rates and a lower cost of capital. Id.; see also, Boston Gas Company, D.P.U. 92-127, at 8 (1992); Boston Edison Company, D.P.U. 91-47, at 12-13 (1991). If the Department authorizes a company to issue debt securities at less than par value, the Department may establish the method by which the company is required to amortize any

discount.[7] G.L. c. 164, § 15A; see, e.g., Boston Gas Company, D.P.U. 92-127, at 8; Boston Edison Company, D.P.U. 91-47, at 15.

C. Authority to Enter Into Derivative Transactions

The Department reviews a request for authority to enter into derivative transactions under the provisions of G.L. c. 164, § 14 applicable to the issuance of long-term debt. New England Power Company, D.P.U. 91-267, at 14 (1992). That is, in order to grant authority to enter into derivative transactions, the Department must assess whether the proposed transaction is reasonably necessary to accomplish some legitimate purpose in meeting a company's service obligations. Id. at 15. In addition, the Department will evaluate the possible savings for ratepayers and the ability of the company to manage the risks associated with the derivative transactions. Id. at 14-15.

VI. ANALYSIS AND FINDINGS

A. Issuance of Long-Term Debt

1. "Reasonably Necessary" Standard

Berkshire has stated that its proposal to issue up to $20 million principal amount of long-term debt is for the purpose of selling the securities and using the proceeds to retire outstanding long-term debt and equity securities, to refinance short-term and long-term debt, for the payment of capital expenditures for additions to property, plant, and equipment, and for

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[7] The discount is the difference between the par value of a bond, note, or other debt security and the actual issue price when the actual issue price is less than par value.

general working capital purposes (Exh. BG-1, at 3; Tr. at 10). The Department has found that issuing debt for the purposes of paying down short-term debt and refinancing long-term debt is a "legitimate utility purpose" as contemplated by G.L. c. 164, § 14. Blackstone Gas Company, D.T.E. 03-65, at 4 (2003); Western Massachusetts Electric Company, D.T.E. 02-49, at 10 (2003); New England Power Company, D.P.U. 95-101, at 11 (1995). Likewise, the Department has found that redeeming existing securities and funding utility operations is a customary purpose of securities issuances. Southern Union Company, D.T.E. 03-3, at 18 (2003); Berkshire Gas Company, D.P.U. 96-64, at 8-9 (1996). Further, the Department has found that issuing securities to fund general working capital requirements is a legitimate utility purpose. Cambridge Electric Light Company, D.P.U. 96-91, at 7 (1996); Commonwealth Electric Company, D.P.U. 92-268, at 6, 8 (1993); Eastern Edison Company, D.P.U. 93-24, at 8, 12 (1993). Accordingly, the Department finds that Berkshire's proposed issuance of long-term debt securities in an aggregate amount up to $20 million is reasonably necessary to accomplish a legitimate purpose in meeting the Company's service obligations in accordance with G.L. c. 164, § 14.

2. Net Plant Test

In regard to the net plant test, the Department requires companies to demonstrate that their net utility plant equals or exceeds their total capitalization pursuant to G.L. c. 164, § 16. Colonial Gas Company, D.P.U. 84-96, at 5 (1984). Berkshire has proposed a number of

adjustments to its capital structure to demonstrate that its proposed financing plan meets the Department's net plant test.

The Company has proposed the inclusion of $5,512,000 in net utility plant associated with anticipated capital investment to be made during the period 2003 through 2006 (Exh. BG-6; RR-DTE-1, Sch. KLZ-5). The Company concedes that this plant does not yet exist. Although a resolution of the labor dispute would result in a more normal level of construction activity, the lack that these projected capital additions do not even have definite construction timetables leads the Department to conclude that the proposed plant additions are not sufficiently known even to be considered for inclusion in the net plant test. Cf. Sheffield Water Company, D.P.U. 92-168, at 7 (1992) (imminent completion of major well addition served to cure impairment of capital stock). We emphasize the distinction in Sheffield Water where the well addition was near completion at the time of the company's financing application (less than two weeks elapsed between the date of the Department's order and the in-service date of the Hubbard Brook well). Sheffield Water stands for a very limited exception under Section 16 arising from the unique facts of that case. To count mere proposed projects effectively as real and as satisfying the requirements of the net plant test is prolepsis plain and simple and, as such, is foreign to what Section 16 demands. Therefore, for purposes of determining the Company's present ability to meet the net plant, the Department will exclude Berkshire's projected net plant additions of $5,512,000 from plant in service.

Additionally, the Company has included a net goodwill balance of $60,660,000[8] in its total plant (RR-DTE-1, Sch. KLZ-5). The purpose of the net plant test is both to protect ratepayers from excessive rates associated with overcapitalization and to assure the creditors of a utility that the company has sufficient tangible assets to cover its liabilities. Boston Gas Company, D.T.E. 03-40, at 321 (2003); Colonial Gas Company, D.P.U. 1247-A at 7 (1982); Report of the Department of Public Utilities Relative to the Capitalization of Gas and Electric Companies, Senate Document No 315, at 8-15 (January 1922). Because goodwill is not directly associated with a utility's tangible plant assets, it is inappropriate to include goodwill for purposes of deriving the net plant test requirement. Southern Union Company, D.T.E. 03-64, at 12 (2003); Southern Union Company, D.T.E. 02-27, at 12 (2002); Southern Union Company, D.T.E. 01-32, at 11 (2001); New England Power Company, D.T.E. 00-53, at 8-9 (2000). Therefore, consistent with well-established precedent, for purposes of determining the Company's present ability to meet the net plant, the Department will exclude Berkshire's net goodwill of $60,660,000 from net plant in service.

Turning to Berkshire's proposed capitalization adjustments, the Company has proposed to exclude $6,000,000 in long-term debt and $20,000 in preferred stock from its capitalization to account for sinking fund payments and debt that is expected to mature in the near future. To date, these redemptions have not yet occurred, and, thus, the securities remain outstanding.

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[8] Consisting of $62,858,000 in goodwill less amortized goodwill of $2,198,000 (Exh. BG-6; RR-DTE-1, Sch. KLZ-5).

Therefore, for purposes of determining the Company's present ability to meet the net plant test, the Department will not use these specific adjustments; therefore, the Department will use a long-term debt balance of $40,000,000 and a preferred stock balance of $250,000.

Turning to Berkshire's paid-in capital balance of $98,455,000, this amount represents the sum of the paid-in capital and retained earnings carried on the Company's books immediately prior to the Energy East acquisition, as well as the goodwill attributed to the Company upon completion of the acquisition (Tr. at 31-32). The Company has proposed to reduce its paid-in capital balance by $4,814,000 to represent the portion that Berkshire considers to be associated with non-utility operations (RR-DTE-1, Sch. KLZ-5). While assets that were financed with paid-in capital may also have certain non-utility applications, the fact remains that the portion of paid-in capital not associated with goodwill was created through the Company's stock issuances, all of which were issued to meet utility purposes.[9] Cf. Southern Union Company, D.T.E. 01-32, at 10-11 (2001) (debt and equity issued in years prior to company coming under Department jurisdiction for the purpose of supporting both regulated and unregulated operations). Therefore, for purposes of determining Berkshire's present ability to meet the net plant test, the Department will not reduce the Company's paid-in capital account for non-utility activities.

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[9] The accounting entries made to recognize the acquisition by Energy East resulted in a commingling of retained earnings, which the Department does not include in the net plant test calculation, with capital that is included in the net plant test (Tr. at 31-32). Although this treatment has the effect of reducing the Company's ability to meet the net plant test, the Department will not disturb the Company's accounting philosophy here.

Berkshire's total unadjusted paid-in capital account of $98,455,000 includes $62,858,000 in goodwill (RR-DTE-1, Schs. KLZ-5, KLZ-7a). Consistent with our treatment of goodwill in the Company's plant investment balance, the Department will exclude $62,858,000 in goodwill from paid-in capital. Southern Union Company, D.T.E. 03-64, at 10 (2003); Southern Union Company, D.T.E. 02-27, at 12 (2002); Southern Union Company, D.T.E. 01-52, at 11 (2001). Therefore, for purposes of determining the Company's present ability to meet the net plant test, the Department will remove goodwill from the paid-in capital balance, resulting in a revised paid-in capital balance of $35,597,000.

Based on the above adjustments, the Department determines that Berkshire's net plant balance is $83,209,000 ($194,661,000 - $62,858,000 - $48,594,000). The Company's total capital supporting these assets, in the form of long-term debt, preferred stock, common stock, and paid-in capital, is $75,847,250 ($40,000,000 + $250,000 + $250 + $35,597,000). Unrestricted approval of the total proposed issuance in this case of $20,000,000 would result in outstanding debt exceeding net utility plant by $12,638,250 ($83,209,000 - $75,847,250 - $20,000,000). The Company's plant investment currently is not sufficient to support the size of the proposed issuance. Rather, Berkshire's current plant investment is sufficient to support the issuance of $7,361,750 in debt.

In similar cases, the Department has approved financings with certain conditions imposed on a company until any net plant impairment had been remedied. See e.g., Commonwealth Electric Company, D.T.E. 02-51, at 7-8 (2002) (securities issuance limited to

amount supported by net plant test; additional, later issuances allowed upon a written showing by the company that it can meet the net plant test); Boston Edison Company, D.T.E. 00-62, at 10-11 (2000) (securities issuance limited solely to amount supported by net plant test); East Northfield Water Company, D.P.U./D.T.E. 97-36, at 6-7 (1997) (restriction on dividend payments and requirement for prior written notification to the Department of capital expenditures exceeding $20,000); Colonial Gas Company, D.P.U. 95-76, at 7-8 (1995) (securities issuance limited to amount supported by net plant test; additional, later issuances allowed after specified date by which record showed that the net plant test would be met); Fitchburg Gas and Electric Light Company. D.P.U. 91-274, at 8 (1992) (requested securities issuance allowed based on identified plan to remove the net plant deficiency); Fitchburg Gas and Electric Light Company. D.P.U. 87-195, at 7-8 (1987) (requested securities issuance allowed contingent upon the submission of a plan approved by the company's board of directors to remedy the net plant deficiency). While Berkshire has proposed to factor in projected plant additions and security redemptions to remedy the impairment, the Department declines to adopt this remedy for the reasons described above. In the alternative, the Company proposed that the Department authorize the issuance of debt up to the limits of available net plant and permit further issuances upon a demonstration that the requirements of G.L. c. 164, § 16 are satisfied (Exh. DTE 1-4; Company Brief at 5).

Having found that the proposed financing is reasonably necessary to meet the Company's service obligations and in accordance with G.L. c. 164, § 14, we will approve the

Company's financing plan with certain conditions to ensure that the value of the Company's existing capital stock will not be impaired. Pursuant to G.L. c. 164, § 16, the Company may issue no more than $7,361,750 in long-term debt on or prior to April 1, 2004.[10] After April 1, 2004, the Company may issue from time to time on or prior to January 31, 2007, up to $12,638,250 in additional debt, provided that it can meet the net plant test at the time of the actual issuance or issuances. Berkshire shall, at least thirty (30) days prior to the time of any issuance after April 1, 2004, provide written certification by the Company's treasurer with competent affidavits and documentation to the Department that sufficient excess net plant is available to support the additional financing. Documentation shall include a schedule similar in format to that provided in Exhibit BG-14 demonstrating that such issuance is consistent with this Order.

Issues concerning the prudence of the Company's capital financing have not been raised in this proceeding, and the Department's decision in this case does not represent a determination that any project is economically beneficial to the Company or its customers. The Department's determination in this Order is not in any way to be construed as a ruling

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[10] General Laws c. 164, § 16, states, in pertinent part, "If, when the [D]epartment approves an issue of new stock, bonds, or other securities by a gas or electric company, it determines that the fair structural value of the plant and of the land . . . owned by such company is less than its outstanding stock and debt, it may prescribe such conditions and requirements as it deems best adapted to make good within a reasonable time the impairment of the capital stock; or before allowing an increase, it may require the capital stock to be reduced by a prescribed amount, not exceeding the amount of such impairment."

relative to the appropriate ratemaking treatment to be accorded any costs associated with the proposed financing.

3. Maximum Interest Rates

Regarding the Company's request for a maximum fixed interest rate of 12 percent per annum and for a maximum adjustable interest rate of 18 percent per annum, the Department recognizes that the potential for financial market volatility requires the allowance of a measure of flexibility in setting maximum interest rates for long-term debt securities. Southern Union Company, D.T.E. 01-32, at 12 (2001). The Company proposed these maximum interest rates based on its consideration that interest rates are in a period of historic lows, but with the expectation that as the economy improves interest rates will rise (Tr. at 41). However, the record of interest rates for A-rated long-term gas utility debt and various maturities of U.S. Treasury yields supports lower maximum rates than those proposed by the Company (Exh. DTE-2-1; RR-DTE-3). The Company stated that a maximum rate of ten percent per annum for the fixed-rate debt and fifteen percent for the adjustable-rate debt would be acceptable (Tr. at 41-42). In view of recent market conditions and long-term economic expectations, the Department finds that a maximum interest fixed rate of 10.0 percent per annum and a maximum adjustable interest rate of 15.0 per annum percent are consistent with the public interest. Accordingly, the Department will authorize a fixed interest rate not in excess of 10.0 percent per annum and an adjustable interest rate not in excess of 15.0 per cent per annum for the issuance of long-term debt securities.

4. Exemptions from G.L. c. 164, §§ 15, 15A

Berkshire represents that an exemption from the competitive bid provisions of G.L. c. 164, § 15 is appropriate because a competitive bid process limits the Company's ability to price and market the securities, as well as to determine the form and timing of an issuance. The Company's negotiated transaction arrangement provides for underwriter assistance in structuring a transaction and pre-marketing of the securities, as well as taking advantage of market opportunities within a matter of hours of their identification (Exh. BG-1, at 13). The Company's private offering arrangement involves financial institutions that have been identified through a competitive approach as potential lenders, including the possible use of a placement agent to assist in the solicitation or evaluation process (Exhs. BG-1, at 17; DTE 1-17; Tr. at 46-47). Based on these considerations, the Department is satisfied that Berkshire's financial solicitation process, as evidenced by its ongoing discussions with potential lenders and placement agents, is sufficiently competitive.

In contrast to the Company's proposed placement process, debt issues with a face value of less than $100,000,000 to $200,000,000 have limited investor appeal under current market conditions (Exh. DTE 1-3; Tr. at 15-16). Moreover, to the extent that an institutional investor would have any interest in Berkshire's proposed financing, the lack of liquidity for a debt issue of this size would result in an additional premium being demanded by the investor of about 25 basis points (Tr. at 17). The Company also has demonstrated that a public offering would result in additional expenses of at least $50,000 compared to a private placement

(Exh. DTE 1-3; Tr. at 15-16). Given the relatively small size of the Company's proposed issuance, the Department is satisfied that a solicitation for competitive bids for public placement would generate little investor interest and result in a higher overall cost of capital.

In light of the foregoing considerations, Berkshire has demonstrated that the benefits of a competitive solicitation process are already enjoyed by its ratepayers. The Department also finds that the additional cost and time associated with a competitive solicitation process would not provide any advantages for ratepayers over those offered by Berkshire's placement process, and would result in higher debt costs for the Company. Therefore, the Department finds that it is in the public interest to exempt the Company from the advertising requirements in G.L. c. 164, § 15.

Regarding the Company's request for an exemption from the par value requirements of G.L. c. 164, § 15A, the Department recognizes that investors rely on, and expect, such discounts as a fine-tuning device to ensure that the coupon rate matches market expectations, thereby allowing increased flexibility in placing debt issues with prospective investors (Exh. DTE 1-1; Tr. at 14-15). Consequently, this increased flexibility translates into an ability to issue debt securities in a timely manner to take advantage of favorable market conditions. Southern Union Company, D.T.E. 03-64, at 14 (2003); Boston Edison Company, D.T.E. 00-62, at 8, 12 (2000); Boston Edison Company, D.T.E. 99-118, at 43 (1999). Therefore, the Department finds that it is in the public interest to exempt the Company from the requirements of G.L. c. 164, § 15A.

Consistent with the requirements of G.L. c. 164, § 15A, the Company has proposed to amortize the amount of any discount from par value over the life of the new issuance series on a straight-line basis. The Department finds that this proposal is in the public interest. Boston Edison Company, D.T.E. 00-62, at 12 (2000). Accordingly, the Company's request is granted.

B. Authority to Enter Into Derivative Transactions

As part of its financing plan, Berkshire proposed to employ certain interest hedging instruments, including interest rate locks, in connection with long-term debt issuances. Berkshire contends that, because the term of the derivative transactions will be less than one year, Department approval of the derivative transactions would not be necessary (Berkshire Petition at 3-4). The Department finds, however, that despite the term of the derivative transactions, Department approval pursuant to G.L. c. 164, § 14 is required because the derivative transactions are directly connected with the issuance of long-term debt. New England Power Company, D.P.U. 91-267, at 14 (1992). It is also important to note that the gain or loss from the derivative transactions will be amortized over the life of the bond or note, with the effective reduction or increase in the cost of debt (Exh. BG-1, at 18). This accounting treatment (extending beyond one year) and the effect on the Company's cost of debt further substantiate the Department's jurisdiction over these derivative transactions under G.L. c. 164, § 14.

The Department has authorized previously the use of derivative transactions associated with the issuance of long-term debt. The Department approved New England Power Company's ("NEP") use of interest rate swaps in connection with NEP's issuance of long-term debt. New England Power Company, D.P.U. 91-267, at 15 (1992). In that order, the Department required that the interest rate swaps be made solely to lock in interest rates associated with the long-term debt issuances, and that NEP not enter into interest rate swaps to speculate on current or future interest rates. Id. at 18. Similarly, the Department allowed the Massachusetts Municipal Wholesale Electric Company to enter into derivative transactions as one means of reducing the risk associated with the issuance of bonds to finance power supply contracts. Massachusetts Municipal Wholesale Electric Company, D.T.E. 99-91, at 15, 21 (2000).

In determining whether to grant authority to employ the proposed derivative instruments, the Department first will consider the purpose of the instruments and then consider the effects on ratepayers. The Company intends to use the derivative instruments, or interest rate locks, to manage interest rate costs and rate exposure up to the issuance date of the debt securities (Exh. BG-1, at 17-18). The Company will not employ these instruments for speculative purposes, and will execute derivative transactions only to manage the floating rate exposure (id. at 19). The Company has stated that all of its derivative activity will be performed consistent with its Derivative Policy, which confines the use of derivatives to risk management or hedging and expressly prohibits speculative derivative transactions (i.e., for

trading) (id; Exh. BG-12). While the use of private placement of the debt securities offers flexibility in the timing of the issuance, as pointed out by the Attorney General, we find that the proper use of derivative instruments can provide further benefits in managing the risk associated with the fluctuation of interest rates. The Department further finds that the ability of the Company to reduce costs and manage its risks is entirely consistent with its duty to provide utility service.

In determining whether to authorize the use of derivative instruments, we agree with the Attorney General that it is necessary to consider the advantages and disadvantages of their use to ratepayers, and to consider the extent to which the Company's control mechanisms may prevent or reduce the risk of harm. If the use of derivative instruments improves the Company's financial position, ratepayers would see an indirect benefit through lower interest expenses. If the use of derivative instruments produces less-than-favorable results, then the Company's interest expenses will increase. All other things being equal, such an increase would reduce the Company's earnings, and, consequently, may reduce the Company's financial strength and corresponding credit rating. A weaker financial condition may result in a higher cost of capital required to fulfill the Company's financial obligations. Therefore, ratepayers potentially would be exposed to indirect risks associated with the Company's use of derivative instruments.

In view of the potential harm, the extent to which control mechanisms may prevent or reduce the risk of ratepayer harm is significant in determining whether to authorize the

Company's use of derivative instruments. The Attorney General raises the possibility that the Company would inappropriately employ derivatives for the profit of shareholders at the expense of ratepayers. However, as noted above, one significant control over the Company's use of derivative transactions is that the instruments will not be use for speculative purposes (Exhs. BG-1, at 19; BG-12). Supporting this policy is the fact that the transactions will not be leveraged (i.e., the principal amount of the derivative will not exceed the underlying value of the debt security) (Exh. BG-12). Another control is the application of accounting requirements of the Securities and Exchange Commission and the Financial Accounting Standards Board, which require financial disclosure of the use of derivatives (Exh. BG-1, at 19). These requirements, in conjunction with any additional reporting requirements that may be imposed on the Company by the Department, will allow both the public and the Department to review the Company's hedging activities and determine whether the activities remain appropriate.

Regarding internal controls over the derivative transactions, the Attorney General questions the appropriateness of the controls and the lack of expertise by Company employees to trade financial derivatives. On the issue of controls, the Company's Derivatives Policy requires that parties that enter into derivative contracts with Berkshire will be limited to nationally recognized dealers in derivatives or other experienced parties with minimum investment-grade senior credit ratings (e.g., A or better rating as published by Standard and Poor's Rating Group) (id.; Exh. BG-12). Regarding the expertise of Company personnel, only senior executives within Energy East may enter into or exit these transactions (Exh. BG-12).

The Company's treasurer's organization will establish credit limits for each counter party prior to any transaction (id.). Each derivative transaction must be supported by a written memorandum to the treasurer's organization stating the strategic objective, the business purpose, and the exit strategy of the transaction (id.). All derivative activity will be reported to the audit committee of the Energy East board of directors, and will include the risk exposure, purpose, and effectiveness of the derivative transaction (id.). Based on the level of personnel involved, the external and internal reporting requirements, the support required for each transaction, and the credit requirements for counter parties, the Department finds that the Attorney General's concerns regarding personnel and internal controls are not supported by the record.

Based on the Company's stated purpose of entering derivative transactions as a means to manage the risk of rate exposure, and not as a means of speculation, the Department finds that the use of financial derivative instruments by the Company is reasonably necessary to meet the Company's service obligations in accordance with G.L. c. 164, § 14. Further, the Department finds that the Company has demonstrated adequate control mechanisms to prevent or reduce the risk of ratepayer harm. Accordingly, the Department grants authorization to the Company to enter into interest rate-related financial derivative transactions in connection with the Company's issuance of long-term debt securities, subject to the conditions stated below.

In order to minimize the risk to the financial integrity of the Company arising from the use of derivative instruments, the Department will allow the Company to enter into derivative

transactions with the following conditions: (1) the use of derivative instruments shall be restricted to interest-rate exposures pertaining to the debt to be issued pursuant to this Order; (2) the Company must comply fully with its Derivatives Policy; (3) the Company must file with the Department any changes in its Derivatives Policy made during the term of its financing plan approved herein; and (4) annually during the term of its financing plan, commencing one year from the date of this Order, and thirty days prior to the filing of a rate case under G.L. c. 164, § 94, the Company shall provide the Department with a written description for all derivative transactions entered into by the Company, including the amount of the transactions, the counter parties involved, the purpose of the transaction, and the results of the transactions to date.

VII. ORDER

Accordingly, after due notice, hearing, and consideration, the Department

VOTES: That the issuance and sale, from time to time on or prior to January 31, 2007, by The Berkshire Gas Company, of long-term debt securities, in an amount not to exceed $20,000,000, is reasonably necessary for the purposes for which such issuance has been authorized; and it is

ORDERED: That the issuance, from time to time on or prior to January 31, 2007, by The Berkshire Gas Company, of long-term debt securities, in an amount not to exceed $20,000,000, is reasonably necessary for the purposes for which such issuance has been authorized; and it is

FURTHER ORDERED: That such authorized long-term debt securities issued by The Berkshire Gas Company shall carry a fixed interest rate not to exceed an effective rate of ten percent per annum, or an adjustable rate to vary with a market index designated at the time of issue or in accordance with a market auction mechanism, but which will not exceed fifteen percent per annum; and it is

FURTHER ORDERED: That The Berkshire Gas Company shall not issue more than $7,361,750 of this long-term debt on or prior to April 1, 2004; and it is

FURTHER ORDERED: That the Berkshire Gas Company may issue up to an additional $12,638,250 of this long-term debt from time to time after April 1, 2004 and on or prior to January 31, 2007, provided that the Company complies with all of the associated directives contained in this Order; and it is

FURTHER ORDERED: That the net proceeds from such sale of all such securities shall be used for the purposes as set forth herein; and it is

FURTHER ORDERED: That The Berkshire Gas Company's issuance and sale, from time to time on or prior to January 31, 2007, of long-term debt securities, in an amount not to exceed $20,000,000, at less than par value, is in the public interest, and such issuance and sale shall be exempt from the provisions of G.L. c. 164, § 15A; and that if a security is sold at less than par value, it is in the public interest to amortize the discount over the life of the security, and the discount shall be amortized over the life of the security; and it is

FURTHER ORDERED: That The Berkshire Gas Company's issuance and sale, form time to time on or prior to January 31, 2007, of long-term debt securities, in an amount not to exceed $20,000,000, without complying with the competitive bidding provisions of G.L. c. 164, § 15, is in the public interest, and that such issuance and sale shall be exempt from the provisions of G.L. c. 164, § 15; and it is

FURTHER ORDERED: That the Secretary of the Department will within three days of the issuance of this Order cause a certified copy of it to be filed with the Secretary of the Commonwealth.

By Order of the Department

_____
Paul G. Afonso, Chairman

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James Connelly, Commissioner

_____
W. Robert Keating, Commissioner

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Eugene J. Sullivan, Commissioner

_____
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).