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Alaska's Asset Portfolio Managing for Maximum Return

A Commonwealth North Study, December 1998

Scott Goldsmith, Nancy Bear Usera, Study Group Co-Chairs

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About Commonwealth North

The mission of Commonwealth North is to educate its members and all Alaskans on relevant public policy issues and to assist in their resolution. The organization addresses state and national long-term issues and involves leaders from Alaska business, labor, education, public service, and Native community. The goals of Commonwealth North include: strengthening the private sector of Alaska's economy, understanding Alaska's role in the larger world, educating members on major issues affecting our state and nation, and influencing state and national public policy decisions.



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Executive Summary

Introduction

Alaska's financial health depends on the state's achieving a sustainable level of revenue sufficient to meet the needs of the state and its people. The Alaska Statehood Compact anticipated the use of publicly held assets for this purpose. Alaska received 104 million acres from the federal government at the time of statehood in 1959. The purposes for the endowment are set forth in Alaska's Constitution. It mandates that the state's land and resources be used, developed, and conserved for maximum benefit of its people.

If managed effectively, these assets have the potential of producing reliable and stable revenues for the state and providing continued economic benefit to the people of Alaska. This is critical to Alaska's future because no income or other individual tax will ever be sufficient to pay for necessary state services and infrastructure.

Commonwealth North wondered if the state could improve its return on these assets. Accordingly, it established a study group with 32 of its members to "identify and recommend unifying policies and principles to guide management of Alaska's public assets to maximize their return and assure their benefit to the people of Alaska."

The study group specifically looked at land and resource assets as well as the business and financial assets the state has created with its oil wealth over the past 20 years. These are the assets that are available for development and that can generate earnings. The study group did not look at conventional public assets such as public schools, office buildings, and transportation infrastructure.

Assumptions

The study's recommendations are predicated on a set of assumptions that reflect underlying principles for successful management and the operating realities of public sector management. These basic assumptions are:

1. The assets which are derived from Alaska's land-grant should be managed consistent with the Constitutional mandate to maximize their use and benefit to the people of Alaska.



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2. The Constitutional prohibition against dedicated funds is recognized as a policy principle which provides that the public interest is served when all state revenues, regardless of source, are available for appropriation by the Legislature to meet Alaska's total needs.
3. There are two types of returns derived from an asset's management: financial and beneficial, and each must directly or indirectly benefit all the people by serving a public purpose.
4. Asset management is most effective within a structure which provides flexibility for maximizing returns while assuring accountability to the state and its people.
5. Performance measures for determining efficiency, results and returns are essential for public accountability.
6. Private enterprise should be the first option for obtaining expertise, goods and services to develop public assets. To the extent that public sector programs compete with the private sector, their activities should be priced in a manner which minimizes adverse effects on private sector competition.
7. Maximizing returns for all assets will enhance revenue to the state as well as provide greater diversity and stability of state revenues.

Recommendations

The result of extensive research, interviews, and discussions is a set of five sequential recommendations for enhancing state revenue, assuring public accountability, and maximizing the use of state assets to benefit Alaskans.

1. Clarify Roles and Responsibilities
 - A. Elected leaders should establish policy and managers should be given authority and flexibility to implement those policies.
 - B. Assets available for development should be managed independently of the organizational authority responsible for promulgating regulations affecting the development of that asset.
 - C. Activities to develop assets and produce returns, to the fullest extent possible, should be carried out by, or in partnership with, the private sector.
2. Measure and Disclose Performance
 - A. Management performance and agency operations should be measured based on meeting mission, efficiency and financial objectives.
 - B. Three types of performance measures should be adopted to evaluate management of each asset:



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1. Appropriate efficiency measures to evaluate the cost of operations.
 2. Measures that show the organization's results in meeting its statutory mission.
 3. Quantifiable measures that state the monetary value of the asset's beneficial and financial returns.
- C. Financial and operational performance based on these measures should be reported to the public annually, for each asset under management, using consistent accounting and reporting standards.
3. Manage Assets as a Portfolio
 - A. The state should strategically manage its assets in a manner that provides for an integrated assessment of risk, potential return, debt, market conditions and cross investment opportunities.
 - B. Financial and beneficial returns on all assets under state management should be annually reported to the public on both an aggregated and individual basis using consistent accounting standards.
 - C. The portfolio of assets should be used strategically to achieve long-term sustainable revenue and return objectives.
 4. Pay Returns to the General Fund
 - A. To the extent that financial returns exceed the need for efficient operations, beneficial returns and appropriate capitalization as determined by the Legislature, they should be deposited into the state Treasury for allocation by the Legislature based on the state's overall priority needs.
 - B. Every asset management organization should have an expectation to contribute a financial return to the state General Fund based on a formula appropriate to its activities and maturity.
 5. Create a System to Achieve These Recommendations
 - A. Establish an integrated system of portfolio management which oversees, monitors and reports asset management performance on an aggregated basis.
 - B. Incorporate state owned natural resources available for development into the state asset management portfolio.

Conclusion

It is in every Alaskan's interest to participate in developing a sustainable system for funding government that is adequate to fulfill the state's obligations. Income taxes, or other methods of individual taxation, will never be sufficient to meet Alaska's financial needs and responsibilities.



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The responsible development, use and management of Alaska's assets are the only means of achieving this goal.

Fortunately, Alaskans already have considerable experience with successful models for state asset management, and must capitalize on those successes. Our purpose in setting forth these recommendations is to stimulate a public dialog on the goals of public asset management and the best means of achieving those goals.

Background and Current Conditions

Alaska received 104 million acres from the federal government at the time of statehood in 1959. The purpose for the endowment was to provide an economic base for the development of the state and to provide the revenues necessary to operate the new state.

The policy of the state, reflected in its Constitution, is to use, develop, and conserve this land and its resources consistent with the public interest for the maximum benefit of its people (Sections 8.1 and 8.2):

8.1. It is the policy of the state to encourage the settlement of its land and the development of its resources by making them available for maximum use consistent with the public interest.

8.2 The legislature shall provide for the utilization, development, and conservation of all natural resources belonging to the state, including land and waters, for the maximum benefit of its people.

The economic history of Alaska since statehood has been largely driven by the development of its petroleum resources, first in Cook Inlet and later on the North Slope. The development of the state's petroleum reserves has resulted in a flow of revenues that has paid virtually the entire cost of operating government and building the physical infrastructure to meet the state's needs. However, recognizing that petroleum is a depleting resource, the state has invested a large portion of the revenue from oil in other, renewable assets with earnings potential. Although the Alaska Permanent Fund is the largest and best known of these, there is an entire portfolio of financial and real assets derived from the transformation of oil. For example, the Alaska Housing Finance Corporation and the Alaska Industrial Development and Export Authority were both



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capitalized with oil revenues. Additionally, Alaska continues to hold a wealth of other resource reserves available for revenue generation through responsible development.

Although oil continues to be the dominant natural resource industry in the state, production has been declining since 1988, and revenues from oil are no longer sufficient to provide for all the needs of state government. Oil revenues will continue to be an important source of state revenues for the foreseeable future. However, the state must increasingly generate other revenues to take their place to provide a stable fiscal future.

The Permanent Fund has become the focus of public attention because it is Alaska's largest asset and because it pays a return directly to all Alaskans. But we cannot overlook the other assets in the state's portfolio that can also make a significant contribution to the state's economic welfare. To maximize the return from these assets, they must be managed strategically and efficiently. The state has considerable experience with successful models for state asset management. However, the question was posed whether there is room for improvement. Accordingly, Commonwealth North formed a study group from its membership to explore the answers to this question and commended it with a charge to meet specific goals.

The Charge and Goals

The Charge

Commonwealth North's board of directors asked the study group to identify and recommend unifying policies and principles to guide management of Alaska's public assets in order to maximize their return and assure that they benefit the people of Alaska.

The Goals

The goals of the study are:

- To encourage and contribute to a public debate about the appropriate management principles applicable to Alaska's public assets;
- To produce a statement defining public expectations for management and return on Alaska's assets; and
- To recommend appropriate business management principles that can be used compatibly with government's obligations to protect the public interest.



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Approach and Methodology

Thirty two Commonwealth North members participated in this study through a series of meetings, discussions and research assignments over a period of six months. Recognizing that a detailed investigation of all state assets was beyond its capabilities, the study group adopted the following guidelines:

1. The study group will evaluate general principles (not the specifics) of the management of Alaska's public assets.
2. The study group will develop a statement of general policy, principles, priorities and recommendations for the improved management of Alaska's public assets.
3. The study will be successful if it encourages and contributes to the public awareness of, and debate about, the appropriate overall management objectives applicable to Alaska's public assets.

The study group limited its investigation to Alaska's land and resource holdings received at the time of statehood, as well as the business and financial assets created with the state's oil wealth. This represents the portfolio of assets available for development and for the generation of earnings to benefit all Alaskans. Excluded from review were the conventional public assets used in the delivery of standard public services such as public schools, office buildings and transportation infrastructure.

Assets in the following agencies were identified:

State Resource Agencies

- Land, Real Estate
- Fish and Game
- Minerals
- Oil and Gas
- Timber

Business Management Agencies

- Marine Highway System
- International Airport System



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Independent Agencies

Created in Statute/Boards Appointed by Governor

- Alaska Permanent Fund Corporation
- Alaska Railroad Corporation
- Alaska Housing Finance Corporation
- Alaska Industrial Development and Export Authority
- Alaska Science and Technology Foundation
- Alaska Aerospace Development Corporation

Independent Support Service Agencies

- Alaska Tourism Marketing Council
- Alaska Seafood Marketing Council
- Alaska Student Loan Corporation
- Alaska Mental Health Trust Authority

Five sub-groups were formed to investigate various categories of assets: financial assets; transportation; land; natural resources; and research, development and support activities. The study group then adopted the following study plan:

Task 1: Gather information

Each sub-group collected information on as many assets as possible, using a standard format. This included information on the management structure of the agency in control of the asset, its mission and goals, its fiscal structure, reporting requirements, methods of evaluation, decision-making process, and planning and projections. (Report addendum available upon request from Commonwealth North.)

Task 2: Management interviews

Each sub-group engaged in a series of discussions with current and former asset managers. These discussions were used not only to collect information on current management practices but also to investigate what works, what does not work, and what improvements could be made in current practices.

Task 3: Determine findings

Based on information and interviews, each sub-group developed a list of preliminary findings covering management practices of the agencies reviewed. This list was synthesized as a result of a series of discussions among all study group members.



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Task 4: Develop recommendations

Based on the findings, the entire study group developed a set of recommendations for management of public assets.

Defining Concepts

Critical to the review was reaching a common understanding of certain basic terms and concepts.

Returns on public assets

In a review of public assets, the concept of "returns" takes on a broader meaning than merely the financial bottom line. In fact, the use of public assets results in two distinct types of returns: financial and beneficial. They are mutually exclusive, but each directly affects the other. Both are intended to satisfy a public purpose.

Financial returns are paid to the Treasury and then appropriated to meet the state's needs. They directly contribute to the state's solvency. Through the appropriation process, these returns are also used to sustain management operations.

Beneficial returns benefit individuals directly through program subsidies, or indirectly through the multiplier effect of job creation and business activity. Beneficial returns serve a public purpose by providing goods and/or services otherwise unavailable or unaffordable to meet a perceived public need. But beneficial returns are not free. They are achieved by a reduction in the financial return potential.

The Alaska Disconnect

The concept of economic development as a public purpose frequently surfaces in evaluating beneficial returns. Clearly, customers, vendors, contractors and others benefit when the state uses its assets for business activity. However, unlike revenue structures in virtually all other states, this business activity does not produce a financial return to the state from personal income tax revenues.

Consequently, the state's expenditures to promote economic development, while laudable, do not produce a direct return on investment. This "Alaska Disconnect" presents a paradox. The more jobs created, the greater the population growth-which results in greater demand for government infrastructure and programs. The demand for government services, including education, creates a need for greater revenue with no off-setting funding source.



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This phenomenon points out the dramatic need to evaluate the cost of beneficial returns. Determining their value provides a means for measuring beneficial returns against the potential for financial return which could be used to help fund state services.

Mission Creep

Most asset development agencies have a mission statement embedded in their authorizing statute. Over time, the activities, priorities and operation of these agencies will normally evolve due to changing needs and outdated programs. This can result in inconsistencies between the agency's activities and its stated mission.

Frequently, however, agency priorities will be driven by other factors that divert resources and interfere with an agency's ability to achieve its mission. These factors can include engaging in activities for which there is additional funding available, or responding to political pressure to participate in specified activities. The result can be performance tied to these external factors, rather than to the agency's primary mission. We call this diversion away from mission direct activities "mission creep".

Assumptions

To evaluate Alaska's current system of asset management, it is important to begin with a common understanding of management standards and performance expectations. The study group used the following assumptions as the basis for its analysis.

1. The assets derived from Alaska's land grant should be managed consistent with the Constitutional mandate to maximize their use and benefit to the people of Alaska.
2. The Constitutional prohibition against dedicated funds is recognized as a policy principle which provides that the public interest is served when all state revenues, regardless of source, are available for appropriation by the Legislature to meet Alaska's total needs.
3. There are two types of returns derived from an asset's management: financial and beneficial. Each must directly or indirectly benefit all the people by serving a public purpose.
4. Asset management is most effective within a structure that provides flexibility for maximizing returns while assuring accountability to the state and its people.
5. Performance measures for determining efficiency, results and returns are essential for public accountability.



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6. Private enterprise should be the first option for obtaining expertise, goods and services to develop public assets. To the extent that public sector programs compete with the private sector, they should be priced in a manner which minimizes adverse effects on private sector competition.
7. Maximizing returns for all assets will enhance revenue to the state, and provide greater diversity and stability of state revenues.

Findings

The study group reviewed Alaska's asset management practices to reach an understanding of the public operating environment and conditions affecting return on assets. The findings listed below describe existing circumstances. Not all findings apply to all agencies or assets. However, each of the findings represents a condition that materially contributes to the state's ability to produce returns and develop its assets.

The findings are statements of fact as perceived by the study group. Most, if not all, of the findings can be interpreted either positively or negatively, depending on the reader's point of view.

Mission and Goals

1. Vague statutory mission statements result in broad and often inconsistent interpretations.
2. Goals are frequently defined by activity rather than by returns.
3. Missions may be adapted because of funding, political prioritization, and short-term expediency, which results in mission creep.
4. The public's interests are not clearly defined or reported.

Performance Standards and Accountability

1. There is no monetary value assigned to or reported on beneficial returns.
2. Performance measures, where they exist, are often tied to activities rather than to mission or returns.
3. There is no standard format for reporting operational costs and benefits returned.



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Structure

1. Regulatory and asset management functions within a single agency are often incompatible for achieving optimum results.
2. Operational mandates created in statute and regulation do not allow for the flexibility necessary to efficiently adapt to evolving missions and priorities.
3. Independent agencies have greater flexibility than executive branch departments in operations and funding.
4. Assets are managed independently, with no portfolio integration that would ensure diversification of risk and return, compatibility in objectives, performance standards and measures, and coordination of activities and reporting.

Management

1. The state's annual budget process does not provide effective integrated review of asset management, does not promote a long-term view of returns, and instead focuses on operational activity as opposed to results.
2. The vagaries of the annual appropriation process and the volatility of state general fund revenues influence asset development potential.
3. Availability of, and access to, alternative funding sources influence operational activity.
4. Politicization of management appointments creates personnel turnover, which impairs continuity and returns.
5. There are few management or budgetary incentives for maximizing returns.
6. Long-term plans, and the accumulation of capital to meet long-term needs, may be used for political purposes, which creates a disincentive for strategic asset management.
7. Special interests significantly influence returns and allocation of returns.

Recommendations

After considerable debate, Commonwealth North offers the following recommendations to Alaskans for their consideration. The recommendations are progressive-that is, each builds on the previous ones toward a more effective asset management system.

1. Clarify Roles and Responsibilities



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- A. Elected leaders should establish policy and managers should be given authority and flexibility to implement those policies.
- B. Assets available for development should be managed independently of the organizational authority responsible for promulgating regulations affecting the development of that asset.
- C. Activities to develop assets and produce returns, to the fullest extent possible, should be carried out by, or in partnership with, the private sector.

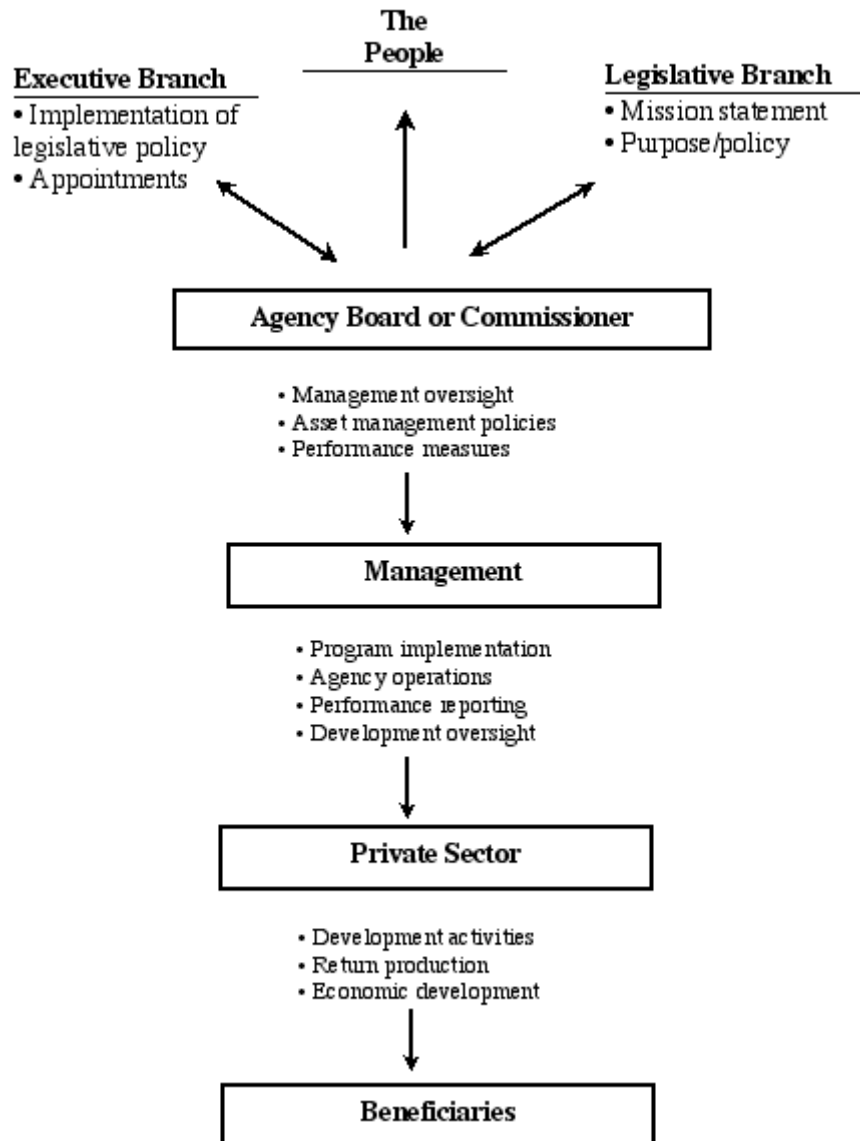


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1. Clarify Roles and Responsibilities



2. Measure and Disclose Performance



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- A. Management performance and agency operations should be measured based on meeting mission, efficiency and financial objectives.
- B. Three types of performance measures should be adopted to evaluate management of each asset:
 - 1. Appropriate efficiency measures to evaluate the cost of operations.
 - 2. Measures that show the organization's results in meeting its statutory mission.
 - 3. Quantifiable measures that state the monetary value of the asset's beneficial and financial returns.
- C. Financial and operational performance based on these measures should be reported to the public annually, for each asset under management, using consistent accounting and reporting standards.

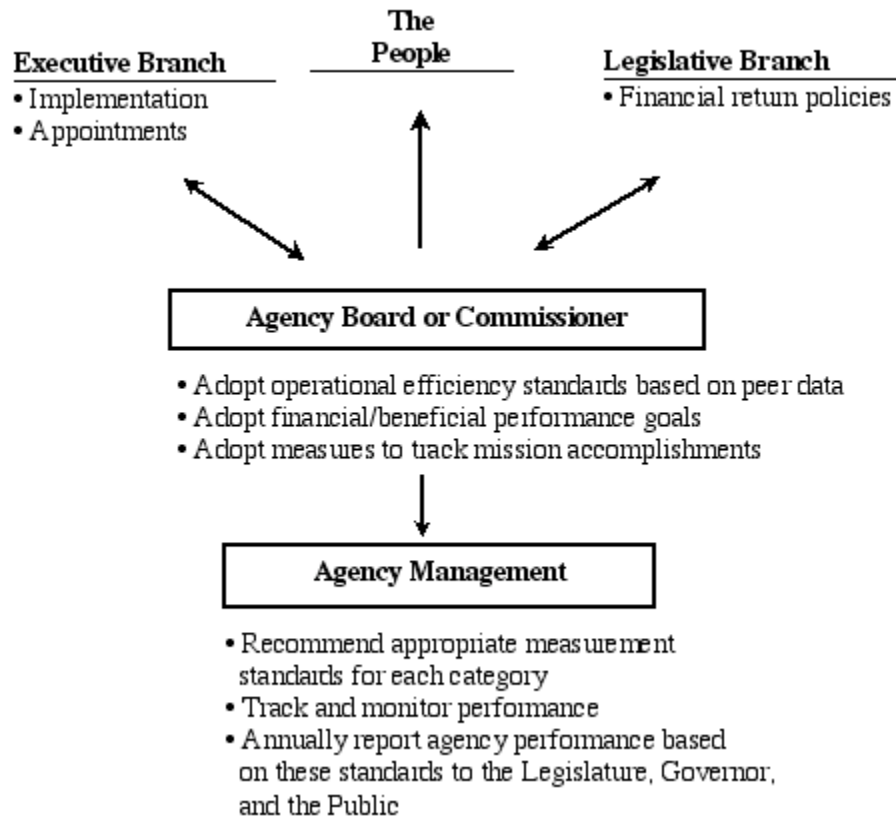


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2. Measure and Disclose Performance



3. Manage Assets as a Portfolio

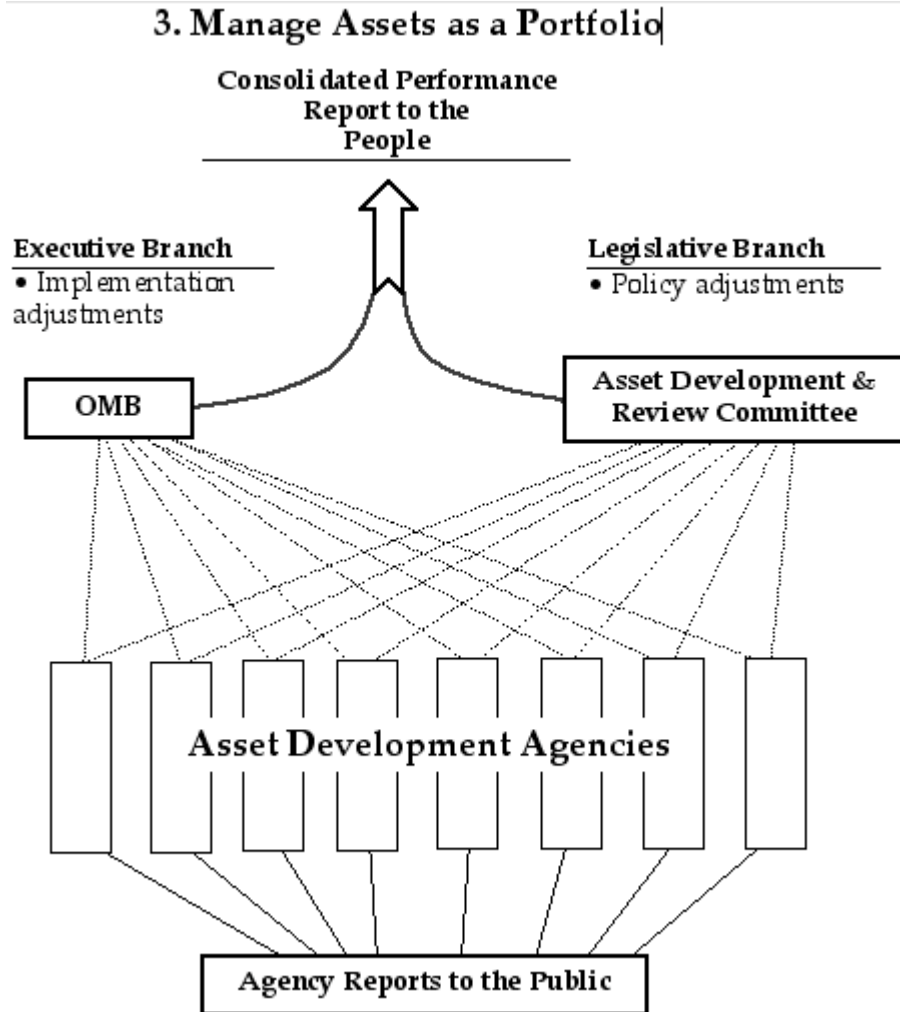
- A. The state should strategically manage its assets in a manner that provides for an integrated assessment of risk, potential return, debt, market conditions and cross investment opportunities.
- B. Financial and beneficial returns on all assets under state management should be annually reported to the public on both an aggregated and individual basis using consistent accounting standards.
- C. The portfolio of assets should be used strategically to achieve long-term sustainable revenue and return objectives.



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4. Pay Returns to the General Fund

- A. To the extent that financial returns exceed the need for efficient operations, beneficial returns and appropriate capitalization as determined by the Legislature, they should be deposited into the state Treasury for allocation by the Legislature based on the state's overall priority needs.



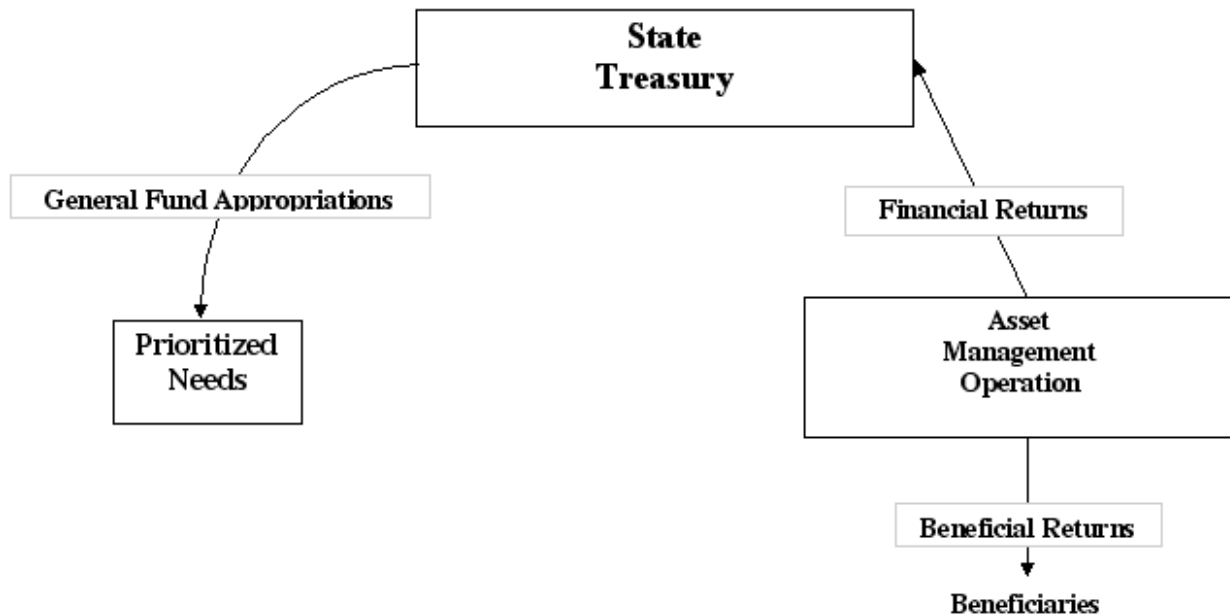
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- B. Every asset management organization should have an expectation to contribute a financial return to the state General Fund based on a formula appropriate to its activities and maturity.

4. Pay Returns to the General Fund

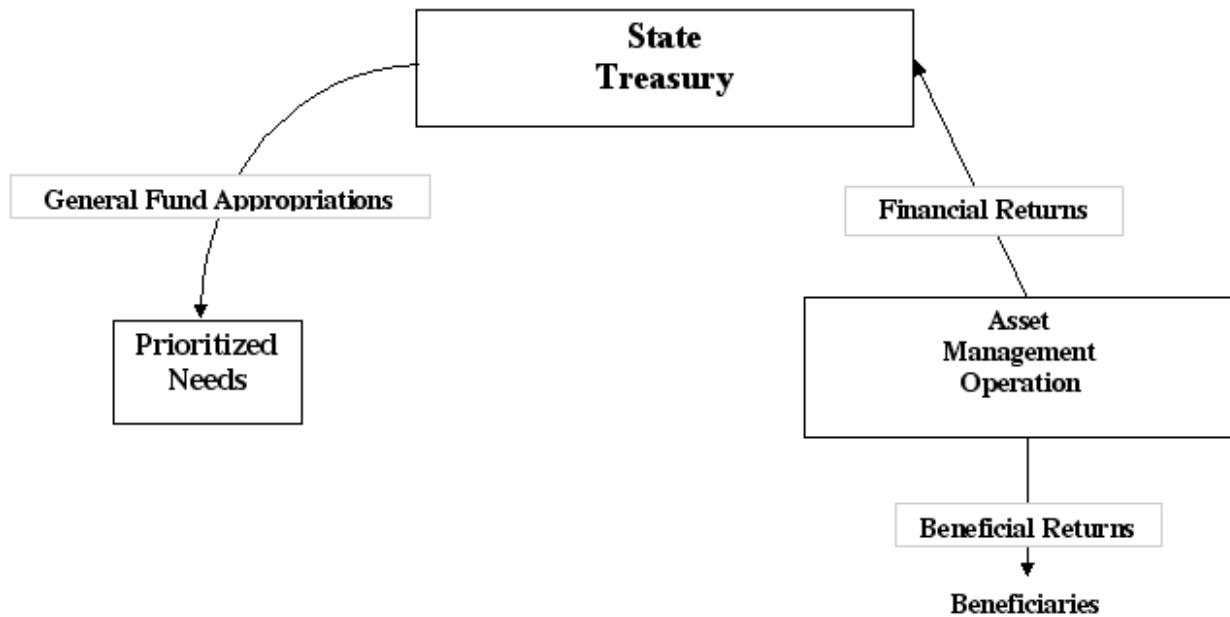


5. Create a System to Achieve These Recommendations
- A. Establish an integrated system of portfolio management which oversees, monitors and reports asset management performance on an aggregated basis.
 - B. Incorporate state owned natural resources available for development into the state asset management portfolio.



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4. Pay Returns to the General Fund



Conclusion

It is in every Alaskan's interest to participate in developing a sustainable system for funding government that is adequate to fulfill the state's obligations. Income taxes, or other methods of individual taxation, will never be sufficient to meet Alaska's financial needs and responsibilities. The responsible development, use and management of Alaska's assets are the only means of achieving this goal.

Fortunately, Alaskans already have considerable experience with successful models for state asset management, and must capitalize on those successes. Our purpose in setting forth these recommendations is to stimulate a public dialog on the goals of public asset management and the best means of achieving those goals.

Acknowledgements

The study group thanks all those who helped in the development of this report, and without whom this study would not have been possible. We particularly appreciate the contributions of



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former and present state asset managers who generously shared their time and perspective. Thanks also go to the Commonwealth North staff and the Hartig Fellow who aided considerably in the completion of this report.

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