Evaluating and Choosing Preferred Projects

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Outline

THE THOUGHT

- Fundamental Question: To what extent is it meaningful to look for "the best"?
- What can we expect to do?
- Value Functions (simple form of Utility)

THE METHODS

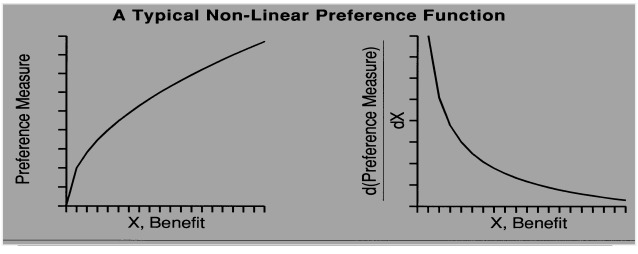
- Target Curves
- Dominant Designs
- Tables

The Thought

- To what extent is it meaningful to look for "the best?"
- What defines "best"?
  - Extreme (high or low) of all other possibilities
- This supposes what?
  - Either (1): we have one metric of performance
  - Or (2): metrics can be put on single scale
- Is (1) realistic? Is (2)?
- Under What Conditions?

Implied Need: "Value Function"

- Definition:
  - V(X) is a means of ranking the relative preference of an individual for a bundle on consequences, X
  - A non-quantitative form of Utility Function



Conditions for a "Value Function"

- **Basic Axioms (1)**
- **Completeness or Complete Preorder**
  - **People have preferences over all $\underline{X}_i$**
- **Transitivity**
  - **If X_1 is preferred to X_2; and X_2 is preferred to X_3 ; Then X_1 is preferred to X_3**
  - **Caution: Assumed True for Individuals; NOT Groups (discussion below)**

Basic Axioms (2)

- **Monotonicity or Archimedean Principle**
  - **For any $\underline{X}_i$ ($\underline{X}^* \geq \underline{X}_i \geq \underline{X}_*$) there is a w (0 < w < 1) such that $V(\underline{X}_i) = w\, V(\underline{X}^*) + (1 - w)\, V(\underline{X}_*)$**
  - **That is, More is Better (or Worse)**

Consequence of V(X) Axioms

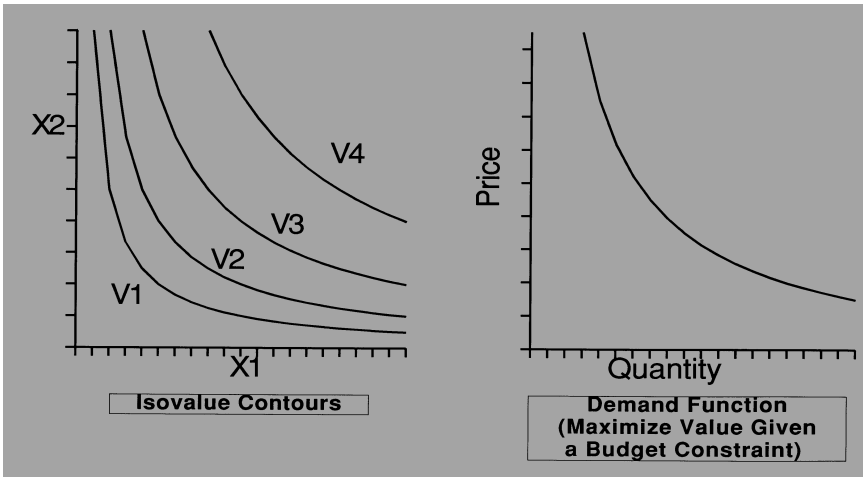
- **Existence of V(X)**
- **Ranking Only**
- **Strategic Equivalence of Many Forms of V(X)**

  Any Monotonic Transform of a V(X) is Still an Equivalent V(X)

  For example:

  $V(X_1, X_2) = X_1^2 X_2 = 2 \log (X_1) + \log (X_2)$

Value Functions



Does this apply to groups?

- Do all members in a group have same preferences?
- Possibly….
- In general, however:
  - Groups composed of stakeholders with different interests (builders, owners, users…)
  - Their interests almost certainly diverge
- Can we expect them to agree?
- NO!

Example Intransitivity for Groups

Voter	Choice Order for Candidate		
	Left	Center	Right
Tom	1	2	3
Diana	3	1	2
Harriet	2	3	1

- WHO WINS ELECTION?
- Left against Center: Left wins 2:1
- Center against Right: Center wins 2:1
- So: Left is preferred to Right? Wrong!!!
- Left against Right: Right wins 2:1 !!!

Where does this leave us?

- Under certain assumptions (conditions), Individuals can rank alternatives (from least to most preferred)
- This does not apply to groups
  - If they agree on a process (set of voting rules)
  - Then, they might be able to agree on a result
  - Arrow's Impossibility Theorem (or Paradox) [No "fair" voting system, without a dictator, satisfies everyone's preferences…]
- So, concept of "best" not meaningful for design of complex systems => "preferred"

Analysis of Outcomes

- What criteria?
- Target Curve, concept and construction
- Robustness?
- Other dimensions
- Hassan satellite example

What can we expect to do?

- First, consider the nature of Problem for Evaluation and Choice
- Evaluation
  - Many dimensions, metrics of performance
  - Uncertainty about them, many states of metrics
  - Best is not defined
  - We can screen out dominated solutions
- Choice
  - Any single person, must see, make TRADEOFFS
  - Groups inevitably have to NEGOTIATE DEAL

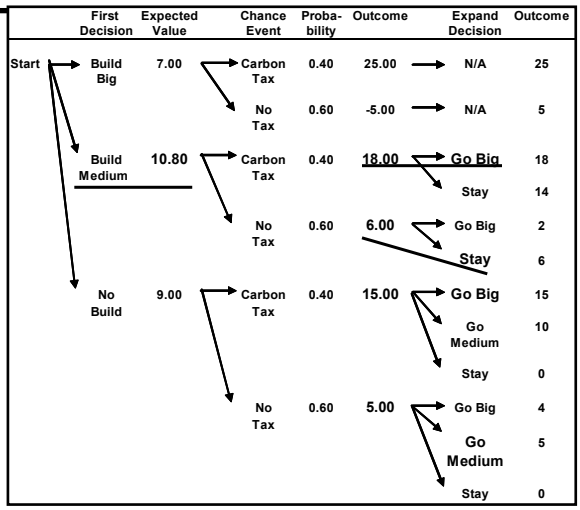
What Criteria?

- "Expected Value" has been the index of choice for valuation…
- Why is this appropriate?
- Is this measure sufficient?

When do we see expected value?

Expected Value based on recognizing possibility of Carbon Tax = 10.8

When do we meet this value?



Conclusion about E(V)

- **A useful single metric**
- **But Insufficient**
- **Cannot describe the range of effects**
  - **This is your A , B, C…**

Other dimensions to explore

- The worst that could happen
  - People are "risk averse", sensitive to loss
  - With some notion of probability of loss
- The best that might occur
  - Upside also important
- Capex (capital expenditure = investment)
- Some measure of Benefit-cost

P_5 , P_{10} or VAR

- P_5 , P_{10} are values for 5%, 10% lowest end of a distribution. The percentage = probability losses do not exceed a particular level.
- VAR is a standard concept in finance = "Value at Risk"
  - P_{10} = 10% VAR
- Motivated by lenders, who are mainly concerned about getting repaid

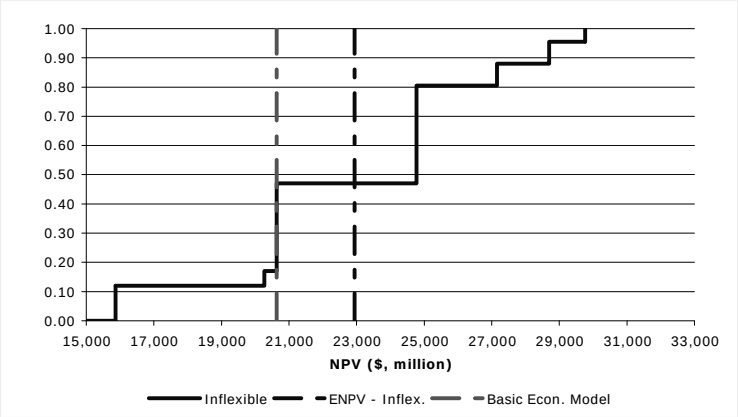
P_{90} , P_{95} or Value at Gain

- We have developed this concept as counterpart of "VAR"
- It represents the upside potential of a project
- Motivated by investors, interested in amount they may gain (not especially interesting to bankers…)

Target curve

- Target curve is the cumulative distribution of outcomes
- Going from worst case at x% probability
- To best case with y% probability
- combines VAR and "Value at Gain"

Target curve for Gulf Oil Case



12% VAR of only 16k; 4% VAG of ~ 30k

How do we construct Target Curve?

See Decision Analysis example

What are elements of Target Curve?

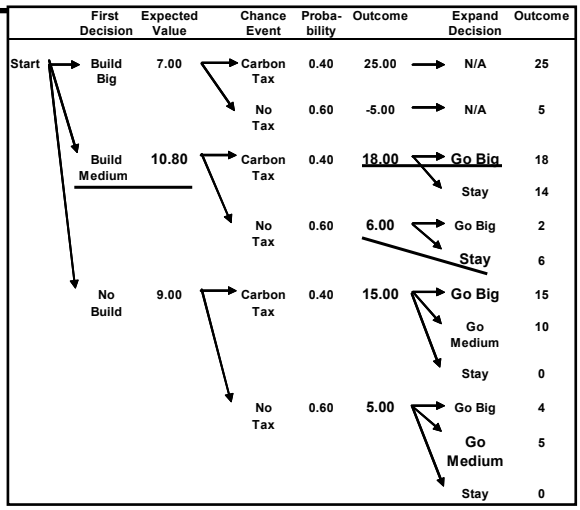
What are possible outcomes?

Answer: 18 and 6

… and associated probabilities?

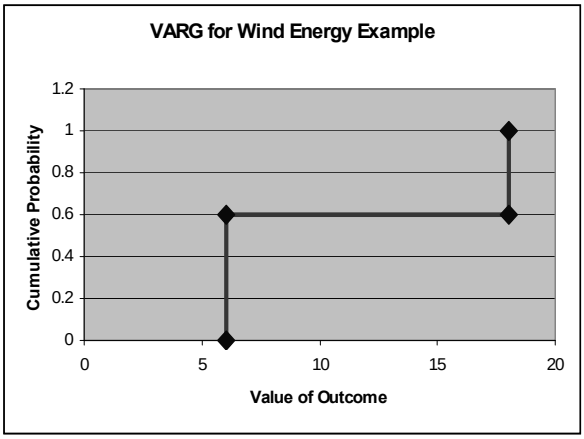
Ans: 0.4 and 0.6

So Target Curve is as on next slide.

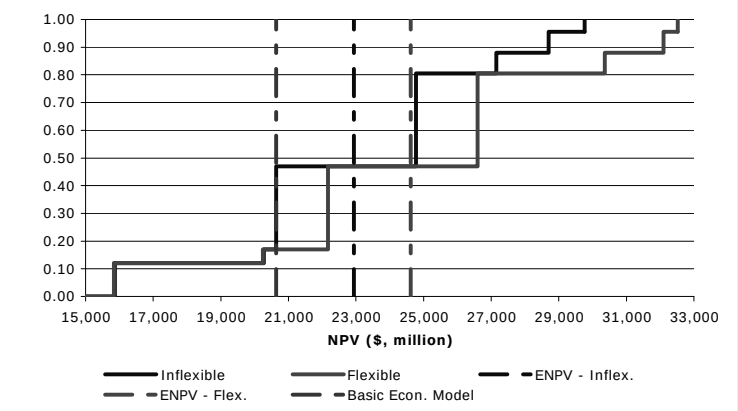


Construction of Target Curve

x , y coordinates	
6	0
6	0.6
18	0.6
18	1



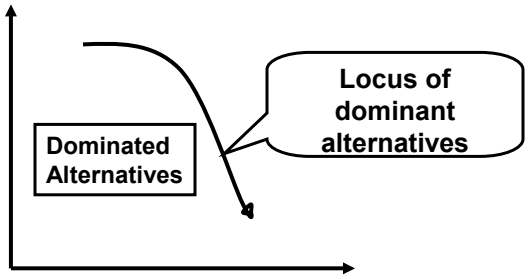
VARG Useful to Compare Alternatives



TARGET CURVES can show relative merit of alternative designs

Concept of "Dominance"

- **Idea: One alternative better than others on all dimensions**



If alternatives are dominated, they can be discarded

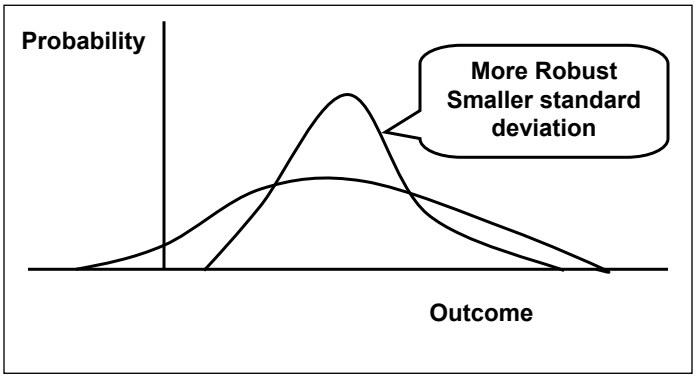
Dominance in Target Curves

- If one Target Curve is always to right of another…
- Does it dominate?
- Yes… but
- Does it mean that one alternative always perform better than the other?
- No! Frequency of occurrence do not translate that way!

Concept of "Robustness"

- Popular Basis for Design ("Taguchi method")
- Robust design ≡ "a product whose performance is <u>minimally sensitive</u> to factors causing variability…"
- Robustness measured by standard deviation of distribution of outcomes

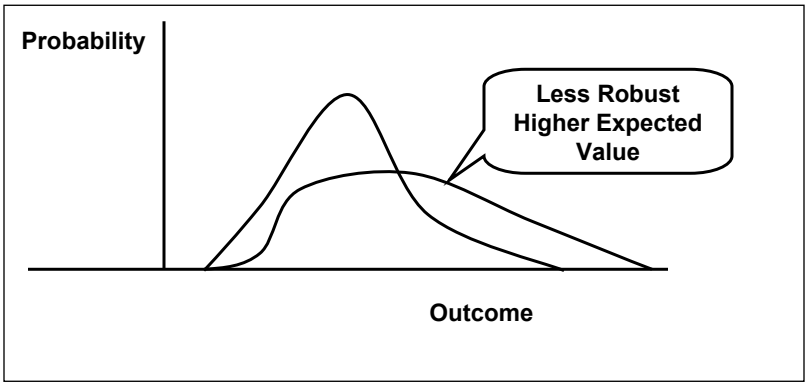
Illustration of Robustness



Do we want robustness?

- When might robustness be a good measure of performance?
- When we really want a particular result
  - Tuning into a signal
  - Fitting parts together, etc
- Is this what we want for maximizing value?
- No!! We want to limit downside but make upside as large as possible => higher σ

Robustness does not maximize expected value



Other Dimensions for Evaluation

- In addition to
  - Expected Value
  - Minimum and Maximum Values
- Capex = Initial Capital Expenditure = Investment
- "Benefit-Cost" ratio of EV / Capex
- Value Added by Flexibility
- Others? … depends on users

Example: Hassan Satellite Case

Architectural Value Parameter ($ million)	Rigid Fleet	Flexible Fleet I	Flexible Fleet II	Flexible Fleet III
E(NPV)	49.94	95.81	56.20	19.40
Std(NPV)	3.69	4.63	3.74	1.63
Flexibility Value	-	45.86	6.26	-30.55
Fixed cost, pay year 1	242	275	341	170
Fixed cost, pay year 6	242	-	-	170
PV(fixed cost) at year 1	392	275	341	276
Maximum possible gain	192	193	142	73
Maximum possible loss	162	68	131	86

Take-Aways: Thoughts

- **Evaluation is complex**
  - **Many metrics of performance**
  - **Plus Uncertainties**
- **Concept of "Best" is problematic**
  - **Individuals may have a value function**
  - **But groups are unlikely to do so**
  - **Especially stakeholders with different interests**
- **Preferred is more realistic concept**
- **Need to show dominating alternatives; Help Decision-Makers see trade-offs**

Take-Aways: Method

- "Expected Value" not sufficient Measure
- Target Curve powerful visual image
  - Shows Maximum and Minimum
  - Compares alternatives
- Tables usefully show
  - Capex
  - Benefit-Cost of "Expected Value / Capex"
  - Value of Flexibility (more on this later)