Robust and Stochastic Optimal Sequential Control

Extended from Chapter 8 of
*Sustainable Management of Natural Resources.
Mathematical Models and Methods
by Luc DOYEN and Michel DE LARA

Michel DE LARA
CERMICS, École des Ponts ParisTech
Université Paris-Est
France

École des Ponts ParisTech

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Outline of the presentation

1. An example of trade-offs in intertemporal optimization
2. Optimization intertemporal criteria under uncertainty
3. The stochastic optimality problem and dynamic programming
4. Applications to stochastic resources optimal management
5. The robust optimality problem and dynamic programming
6. Summary
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In 2012, the Botanic Garden in Mauritius Island witnessed an exceptional blooming of the talipot palm

- In 2012, at Sir Seewoosagur Ramgoolam Botanic Garden in Mauritius Island, the talipot palm *Corypha umbraculifera* was in bloom.
- This remarkable event occurs only once in the life of this species (monocarpic).
- The palm flowers only once, when it is 30 to 80 years old, produces fruits, and dies after fruiting.
Here are intertemporal trade-offs related to growth

- Organisms (vegetal, animal) trade growth vs. reproduction to achieve the largest number of offspring
  - The bigger a plant today, the bigger tomorrow (leaves and roots capturing more resources)
  - Therefore, it might be interesting to postpone reproduction and convert all final biomass into seeds
  - But, if the environment is hostile in the sense that the plant faces a sequence of independent death threats, it may be better to start reproducing early
  - Fishes and snakes grow and reproduce during all their life time (wild salmon dies after spawning)

- Investing is refraining from consuming now at the benefit of more consumption in one year at the expense of being dead in one year (the first reason for discounting the future)
Plants display a large spectrum of life-history patterns

(Mark Kot, *Elements of Mathematical Ecology*)

- Herbs often flower in their first year and then die, roots and all, after setting seed
- Plants that flower once and then die are *monocarpic, semelparous*
  - Bamboos are grasses but they grow to unusually large size. One Japanese species, *Phyllostachys bambusoides*, waits 120 years to flower (Janzen, 1976)
  - Most trees flower repeatedly. However, Foster (1977) has characterized *Tachigalia versicolor* as a 'suicidal neotropical tree'. After reaching heights of 30-40 m, it flowers once and then dies
A stochastic control model of plant growth

The model is a discrete time one with time variable \( t \in \{0, 1, 2 \ldots \} \)

1. At the beginning of each time interval \([t, t+1]\),
   - the plant is characterized by its \textit{vegetative biomass} \( k_t \in [0, +\infty[ \)
   - and by the \textit{cumulated reproductive biomass} \( S_t \in [0, +\infty[ \)

2. At the end of each time interval \([t, t+1]\),
   the vegetative biomass \( k_{t+1} \) is at most \( f(k_t) \),

\[
0 \leq k_{t+1} \leq f(k_t)
\]

where \( f \) is the \textit{growth function}
An example of trade-offs in intertemporal optimization

The growth of a plant in one period is modeled by a strictly increasing and strictly concave function.

Concerning the (gross) growth function $f : \mathbb{R}_+ \to \mathbb{R}$, we make the following assumptions:

- $f$ is continuous
- $f(0) = 0$
- $f(k) > 0$ for $k > 0$
- $f$ is strictly increasing: $f' > 0$
- $f$ is strictly concave: $f'' < 0$
A stochastic control model of plant growth

At the beginning of each time interval \([t, t + 1]\),
- the plant is characterized by its **vegetative biomass** \(k_t \in [0, +\infty[\)
- and by the **cumulated reproductive biomass** \(S_t \in [0, +\infty[\)

During each time interval \([t, t + 1]\),
- the plant allocates biomass \(u_t\) as vegetative biomass, with \(0 \leq u_t \leq f(k_t)\)
- and \(f(k_t) - u_t\) as reproductive biomass in the interval \([t, t + 1]\)

At the end of each time interval \([t, t + 1]\),
- the cumulated reproductive biomass is
  \[S_{t+1} = S_0 + \sum_{s=0}^{t}[f(k_s) - u_s] = S_t + [f(k_t) - u_t]\]
- the plant vegetative biomass is \(k_{t+1}\)
  - either \(k_{t+1} = u_t\) with probability \(p\) (survival)
  - or \(k_{t+1} = 0\) with probability \(1 - p\) (death)
Bellman function and Bellman equation

- Define $V(k)$, the maximal number of offspring when starting from $k_0 = k$

$$V(k) = \max_{u(\cdot)} \mathbb{E} \left[ \sum_{t=0}^{+\infty} (f(k_t) - u_t) \right], \quad k_0 = k$$

- Now, when the plant allocates biomass $u \in [0, f(k)]$ as vegetative biomass
  - on the one hand, it enjoys offspring $f(k) - u$,
  - on the other hand, it achieves vegetative biomass $k_1 = u$ with probability $p$, and vegetative biomass $k_1 = 0$ with probability $1 - p$

- Therefore, we have that

$$V(k) = \max_{0 \leq u \leq f(k)} \left( f(k) - u + pV(u) + (1 - p)V(0) \right)$$

- Supposing that $f(0) = 0$, we obtain the Bellman equation

$$V(k) = \max_{0 \leq u \leq f(k)} \left( f(k) - u + pV(u) \right)$$
Let us analyze the Bellman equation

- Define the operator $J$, mapping function $\phi$ towards function $J\phi$, by

\[
(J\phi)(k) = \max_{0 \leq u \leq f(k)} \left( f(k) - u + p\phi(u) \right)
\]

so that the Bellman function $V$ solves $V = JV$

- Show that $k \mapsto (J\phi)(k)$ is increasing
- Show that the operator $J$ is strictly contracting, when $p < 1$
- Show that the operator $J$ maps concave functions onto concave functions
- Deduce that $V$ is unique, and is increasing and concave
- Supposing that $V$ is smooth and strictly increasing, and that there exists a unique scalar $k_p$ that solves $V'(k_p) = 1/p$, characterize the optimal policy
- Show that

\[
V'(k_p) = f'(k_p) = \frac{1}{p}
\]
Optimal growth strategies and patterns

- In the case where \( k_p \leq f(k_p) \),
  \[
  \text{Pol}^*(k) = \begin{cases} 
  f(k) & \text{if } k \leq f^{-1}(k_p) \\
  k_p & \text{if } k \geq f^{-1}(k_p) 
  \end{cases}
  \]

- Draw optimal trajectories \( t \mapsto k_t \) for the vegetative biomass

- What happens to \( k_p \) and to the optimal trajectories when the survival probability \( p \) decreases from 1 to 0?

- “The decline in weight of trophy ivory obtained from Uganda elephants between 1925 and 1958 is significant, with an average tusk weight of 55 pounds in 1926 declining to 40 pounds in 1958.”, from *Trend in tusk size of the Uganda elephant*, by Allan C. Brooks and Irven O. Buss

- Fish reproduce earlier at a smaller size, after heavy fishing pressure
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Carbon cycle model and uncertain damages

- \( \text{CO}_2 \) concentration \( M(t) \)

\[
M(t + 1) = M(t) - \delta(M(t) - M_\infty) + \alpha \text{Emiss}(t) (1 - a(t))
\]

- decision \( a(t) \in [0, 1] \) is the abatement rate of \( \text{CO}_2 \) emissions.
Mitigation for climate change under uncertainty

- Three periods: $t = 0$ (today), $t = 1$ (in twenty-five years), $t = 2$ (in fifty years)
- First-period abatement cost $\text{Cost}(a(0))$
- Discounted second-period abatement cost $\delta \text{Cost}(a(1))$, where $\delta = \frac{1}{1 + r_e}$
- Discounted final damage cost $\delta^2 \text{Damage}(M(2), \theta(2))$ depends on
  - CO$_2$ final concentration $M(2)$
  - Uncertain damage sensitivity to climate $\theta(2)$ in fifty years

Total costs are $\text{Crit}(M(\cdot), a(\cdot), \theta(\cdot)) =$

$$\text{Cost}(a(0)) + \delta \text{Cost}(a(1)) + \delta^2 \text{Damage}(M(2), \theta(2))$$

and they depend upon the uncertainty $\theta(2)$
Optimal single dam management

\[ A_t, R_t, Q_t, S_t \]
A single dam nonlinear dynamical model in decision-hazard

We can model the dynamics of the water volume in a dam by

\[
S(t+1) = \min\{S^#, S(t) - q(t) + a(t)\}
\]

future volume \hspace{1cm} volume \hspace{1cm} turbined \hspace{1cm} inflow volume

- \textit{S(t)} volume (stock) of water at the beginning of period \([t, t+1]\)
- \textit{a(t)} inflow water volume (rain, etc.) during \([t, t+1]\)
- decision-hazard:
  - \textit{a(t)} is not available at the beginning of period \([t, t+1]\)
- \textit{q(t)} turbined outflow volume during \([t, t+1]\)
  - decided at the beginning of period \([t, t+1]\)
  - supposed to depend on \(S(t)\) but not on \(a(t)\)
  - chosen such that \(0 \leq q(t) \leq S(t)\)
The traditional economic problem is maximizing the expected payoff

Suppose that

- a probability $\mathbb{P}$ is given on the set $\Omega = \mathbb{R}^{T-t_0}$ of water inflows scenarios $(a(t_0), \ldots, a(T-1))$
- turbined water $q(t)$ is sold at price $p(t)$, related to the price at which energy can be sold at time $t$
- at the horizon, the final volume $S(T)$ has a value $K(S(T))$, the “final value of water”

The traditional economic problem is to maximize the intertemporal payoff (without discounting if the horizon is short)

$$\max \mathbb{E} \left[ \sum_{t=t_0}^{T-1} p(t)q(t) + K(S(T)) \right]$$
Uncertainty variables are new input variables in a discrete-time nonlinear state-control system

A specific output is distinguished, and is labeled "state" (more on this later), when the system may be written

$$x(t + 1) = \text{Dyn}(t, x(t), u(t), w(t)), \quad t \in \mathbb{T} = \{t_0, t_0 + 1, \ldots, T - 1\}$$

- **time** $t \in \bar{T} = \{t_0, t_0 + 1, \ldots, T - 1, T\} \subset \mathbb{N}$
  (the time period $[t, t + 1]$ may be a year, a month, etc.)
- **state** $x(t) \in X := \mathbb{R}^n$ (biomasses, abundances, etc.)
- **control** $u(t) \in U := \mathbb{R}^p$ (catches or harvesting effort)
- **uncertainty** $w(t) \in W := \mathbb{R}^q$
  (recruitment or mortality uncertainties, climate fluctuations or trends, etc.)
- **dynamics** $\text{Dyn}$ maps $\mathbb{T} \times X \times U \times W$ into $X$
  (biomass model, age-class model, economic model)
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Histories and criterion for the single dam optimization problem

Single dam histories

\[(S(\cdot), q(\cdot)) = (S(t_0), \ldots, S(T), q(t_0), \ldots, q(T - 1))\]

Intertemporal payoff for a single dam

\[
\text{Crit}(S(\cdot), q(\cdot)) = \sum_{t=t_0}^{T-1} \frac{\text{turbined water profit}}{p(t) \times q(t)} + \frac{\text{final stock utility}}{K(S(T))}
\]
An intertemporal criterion attaches a value to a history and performs an aggregation with respect to time, reflecting preferences across time.

- The **history space** is
  $$\mathcal{H} := X^{T+1-t_0} \times U^{T-t_0} \times W^{T+1-t_0}$$
  - state
  - control
  - uncertainty

- A **criterion** $\text{Crit}$ is a function
  $$\text{Crit} : \mathcal{H} \rightarrow \mathbb{R}$$

  which assigns
  - a scalar value $\text{Crit}(x(\cdot), u(\cdot), w(\cdot)) \in \mathbb{R}$
  - to a history $(x(\cdot), u(\cdot), w(\cdot)) \in \mathcal{H}$
The additive criterion is the most common and sums payoffs over time-periods

- The traditional discounted present value is

\[
\sum_{t=t_0}^{+\infty} \delta^{t-t_0} L(x(t), u(t), w(t))
\]

- The time-separable additive criterion includes discounted present value, Green Golden, Chichilnisky

\[
\text{Crit}(x(\cdot), u(\cdot), w(\cdot)) = \sum_{t=t_0}^{T-1} L(t, x(t), u(t), w(t)) + K(x(T), w(T))
\]

- The payoffs in one time-period may be compensated by those of other time-periods
The maximin criterion focuses on the worst payoff across time-periods.

- **Equity**: a focus on the poorest generation
- The maximin form or Rawls criterion is

\[
\text{Crit}(x(\cdot), u(\cdot), w(\cdot)) = \min_{t=t_0, \ldots, T-1} \min_{\text{worse generation utility}} L(t, x(t), u(t), w(t))
\]
Summary

A criterion attaches a value to a history and performs an aggregation with respect to time, reflecting preferences across time.

How can we attach a value to a policy, so that we can rank policies?
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An example of state and control solution maps

Volume and turbined trajectories under a given policy

Consider a dam modeled as $S(t + 1) = S(t) - q(t) + a(t)$, where there is no spilling by supposing that the total volume $S^\# = +\infty$, and pick up

- a scenario $a(\cdot) = (a(t_0), a(t_0 + 1), \ldots, a(T))$ of water inflows
- a policy $Pol(t, S) = \alpha(t)S$ with $0 \leq \alpha(t) \leq 1$
- an initial state (volume) $S(t_0)$

1. Initial decision $q(t_0) = \alpha(t_0)S(t_0)$
2. Second state $S(t_0 + 1) = (1 - \alpha(t_0))S(t_0) + a(t_0)$
3. Second decision
   
   $q(t_0 + 1) = \alpha(t_0 + 1)S(t_0 + 1) = \alpha(t_0 + 1)\left((1 - \alpha(t_0))S(t_0) + a(t_0)\right)$

4. And so on $S(t_0 + 2) = (1 - \alpha(t_0 + 1))S(t_0 + 1) + a(t_0 + 1) = (1 - \alpha(t_0 + 1))(1 - \alpha(t_0))S(t_0) + (1 - \alpha(t_0 + 1))a(t_0) + a(t_0 + 1)$

5. \ldots
Admissible state feedback policies express control constraints

The control constraints case restricts policies to admissible policies

\[ U^{ad} := \{ \text{Pol} : T \times X \rightarrow U \mid \text{Pol}(t, x) \in B(t, x), \ \forall (t, x) \} \]

Dam management physical volume constraint

In a water reservoir, the output flow (control) cannot be more than the stock volume (state) and than a capacity constraint

\[ 0 \leq q(t) \leq S(t) \ \text{and} \ 0 \leq q(t) \leq q^\# \]

For instance, a dam management policy of the form

\[ \text{Pol}(t, S) = \max\{q^\flat, \min\{\alpha(t)S, q^\#, S\}\} \]

is admissible, where \( 0 \leq q^\flat \leq q^\# \) captures a requirement of minimal outflow (for biodiversity preservation in downward rivers, for instance)
A policy and a scenario yield a history that is evaluated by a criterion (time aggregation)

Turbined and final volume payoff under a given policy

Plug the solution maps

1. $q(t_0) = \alpha(t_0)S(t_0)$
2. $S(t_0 + 1) = (1 - \alpha(t_0))S(t_0) + a(t_0)$
3. $q(t_0 + 1) = \alpha(t_0 + 1)(1 - \alpha(t_0))S(t_0) + a(t_0)$
4. $S(t_0 + 2) = (1 - \alpha(t_0 + 1))(1 - \alpha(t_0))S(t_0) + (1 - \alpha(t_0 + 1))a(t_0) + a(t_0 + 1)$
5. ...

into the criterion

$$\text{Crit}(S(\cdot), q(\cdot), a(\cdot)) = \sum_{t=t_0}^{T-1} \text{water release profit} \quad \text{final stock utility}$$

$$p(t)q(t) + K(S(T))$$
A policy and a scenario yield a history that is evaluated by a criterion (time aggregation)

- The criterion $\text{Crit}$ maps the history space $\mathbb{H}$ towards $\mathbb{R}$
- For $t_0$ the initial time, and $x_0 \in \mathbb{X}$ the initial state, the evaluation of the criterion is

$$
\text{Crit}^{\text{pol}}(t_0, x_0, w(\cdot)) := \text{Crit}(X_{\text{Dyn}}[t_0, x_0, \text{Pol}, w(\cdot)](\cdot), U_{\text{Dyn}}[t_0, x_0, \text{Pol}, w(\cdot)](\cdot), w(\cdot)) \in \mathbb{R}
$$

state trajectory control trajectory
A policy and a criterion yield a real-valued payoff

Given a policy $\text{Pol} \in \mathcal{U}^{ad}$ and a scenario $w(\cdot) \in \Omega$, we obtain a payoff

$$\text{Payoff}(\text{Pol}, w(\cdot)) = \text{Crit}^{\text{Pol}}(t_0, x_0, w(\cdot))$$

hence a mapping $\mathcal{U}^{ad} \times \Omega \rightarrow \mathbb{R}$

<table>
<thead>
<tr>
<th>Policies/Scenarios</th>
<th>$w^A(\cdot) \in \Omega$</th>
<th>$w^B(\cdot) \in \Omega$</th>
<th>...</th>
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</thead>
<tbody>
<tr>
<td>$\text{Pol}_1 \in \mathcal{U}^{ad}$</td>
<td>$\text{Payoff}(\text{Pol}_1, w^A(\cdot))$</td>
<td>$\text{Payoff}(\text{Pol}_1, w^B(\cdot))$</td>
<td>...</td>
</tr>
<tr>
<td>$\text{Pol}_2 \in \mathcal{U}^{ad}$</td>
<td>$\text{Payoff}(\text{Pol}_2, w^A(\cdot))$</td>
<td>$\text{Payoff}(\text{Pol}_2, w^B(\cdot))$</td>
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<tr>
<td>...</td>
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</table>
Summary

- An intertemporal criterion $\text{Crit}$ attaches a value to a history and performs an aggregation with respect to time, reflecting preferences across time.

- A policy $\text{Pol}$ and a scenario $w(\cdot)$ yield a history, thanks to the state and control solution maps, that is evaluated by a criterion $\text{Crit}$ (time aggregation), yielding $\text{Crit}^{\text{Pol}}(t_0, x_0, w(\cdot))$.

- A policy $\text{Pol}$ and a criterion $\text{Crit}$ yield a real-valued mapping $w(\cdot) \in \Omega \mapsto \text{Payoff}(\text{Pol}, w(\cdot)) = \text{Crit}^{\text{Pol}}(t_0, x_0, w(\cdot))$ over the scenarios $\Omega$.

- Therefore, comparing policies amounts to comparing mappings over the scenarios $\Omega$.

- For this purpose, we will see how to aggregate the real-valued mapping $w(\cdot) \in \Omega \mapsto \text{Payoff}(\text{Pol}, w(\cdot))$ with respect to scenarios.
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In the robust or pessimistic approach, Nature is supposed to be malevolent, and the DM aims at protection against all odds.
In the robust or pessimistic approach, Nature is supposed to be malevolent.

- In the robust approach, the DM considers the worst payoff:
  \[
  \min_{w(\cdot) \in \Omega} \text{Payoff}(\text{Pol}, w(\cdot))
  \]

- Nature is supposed to be malevolent, and specifically selects the worst scenario: the DM plays after Nature has played, and maximizes the worst payoff:
  \[
  \max_{\text{Pol} \in \mathcal{U}^{\text{ad}}} \min_{w(\cdot) \in \Omega} \text{Payoff}(\text{Pol}, w(\cdot))
  \]

- Robust, pessimistic, worst-case, maximin, minimax (for costs)

Guaranteed energy production

In a dam, the minimal energy production in a given period, corresponding to the worst water inflow scenario.
The robust approach can be softened with plausibility weighting

- Let $\Theta : \Omega \to \mathbb{R} \cup \{-\infty\}$ be a plausibility function.
- The higher, the more plausible:
  totally implausible scenarios are those for which $\Theta(w(\cdot)) = -\infty$
- Nature is malevolent, and specifically selects the worst scenario, but weighs it according to the plausibility function $\Theta$
- The DM plays after Nature has played, and solves

$$\max_{Pol \in \mathcal{U}^{ad}} \min_{w(\cdot) \in \Omega} \left( \text{Payoff}(Pol, w(\cdot)) - \Theta(w(\cdot)) \right)$$
In the optimistic approach, Nature is supposed to benevolent.

Future. That period of time in which our affairs prosper, our friends are true and our happiness is assured.

Ambrose Bierce

- Instead of maximizing the worst payoff as in a robust approach, the optimistic perspective focuses on the **most favorable payoff**

\[
\max_{w(\cdot) \in \Omega} \text{Payoff}(\text{Pol}, w(\cdot))
\]

- Nature is supposed to benevolent, and specifically selects the best scenario: the DM plays after Nature has played, and solves

\[
\max_{\text{Pol} \in \mathcal{U}^{ad}} \max_{w(\cdot) \in \Omega} \text{Payoff}(\text{Pol}, w(\cdot))
\]
The Hurwicz criterion reflects an intermediate attitude between optimistic and pessimistic approaches.

A proportion $\alpha \in [0, 1]$ graduates the level of prudence.

$$\max_{\text{Pol} \in U^{ad}} \left\{ \alpha \min_{w(\cdot) \in \Omega} \text{Payoff}(\text{Pol}, w(\cdot)) + (1 - \alpha) \max_{w(\cdot) \in \Omega} \text{Payoff}(\text{Pol}, w(\cdot)) \right\}$$
In the stochastic or expected approach, Nature is supposed to play stochastically.
In the stochastic or expected approach, Nature is supposed to play stochastically

- The expected payoff is
  \[
  \mathbb{E}\left[\text{Payoff}(\text{Pol}, w(\cdot))\right] = \sum_{w(\cdot) \in \Omega} P\{w(\cdot)\} \text{Payoff}(\text{Pol}, w(\cdot))
  \]

- Nature is supposed to play stochastically, according to distribution \(P\): the DM plays after Nature has played, and solves
  \[
  \max_{\text{Pol} \in \mathcal{U}^{ad}} \mathbb{E}\left[\text{Payoff}(\text{Pol}, w(\cdot))\right]
  \]

- The discounted expected utility is the special case
  \[
  \mathbb{E}\left[\sum_{t=t_0}^{+\infty} \delta^{t-t_0} L(x(t), u(t), w(t))\right]
  \]
The expected utility approach distorts payoffs before taking the expectation

- We consider a utility function $L$ to assess the utility of the payoffs (for instance a CARA exponential utility function).
- The expected utility is

\[
\mathbb{E} \left[ L\left( \text{Payoff}(\text{Pol}, w(\cdot)) \right) \right] = \sum_{w(\cdot) \in \Omega} \mathbb{P}\{w(\cdot)\} L\left( \text{Payoff}(\text{Pol}, w(\cdot)) \right)
\]

- The expected utility maximizer solves

\[
\max_{\text{Pol} \in \mathcal{U}^{ad}} \mathbb{E} \left[ L\left( \text{Payoff}(\text{Pol}, w(\cdot)) \right) \right]
\]
The ambiguity or multi-prior approach combines robust and expected criterion

- Different probabilities $P$, termed as beliefs or priors, and belonging to a set $P$ of admissible probabilities on $\Omega$.
- The multi-prior approach combines robust and expected criterion, by taking the worst beliefs in terms of expected payoff.

\[
\max_{Pol \in U^{ad}} \min_{P \in P} \mathbb{E}^P \left[ \text{Payoff}(Pol, w(\cdot)) \right]
\]

mean payoff

pessimistic over probabilities
Convex risk measures cover a wide range of risk criteria

- Different probabilities $\mathbb{P}$, termed as beliefs or priors, and belonging to a set $\mathcal{P}$ of admissible probabilities on $\Omega$.
- To each probability $\mathbb{P}$ is attached a plausibility $\Theta(\mathbb{P})$.

\[
\max_{\text{Pol} \in \mathcal{U}^{ad}} \min_{\mathbb{P} \in \mathcal{P}} \mathbb{E}^{\mathbb{P}} \left[ \text{Payoff}(\text{Pol}, w(\cdot)) \right] - \Theta(\mathbb{P})
\]

This expression is pessimistic over probabilities.
Non convex risk measures can lead to non diversification

Imagine yourself at a casino with $1,000. For some reason, you desperately need $10,000 by morning; anything less is worth nothing for your purpose.

The only thing possible is to gamble away your last cent, if need be, in an attempt to reach the target sum of $10,000.

- The question is how to play, not whether. What ought you do? How should you play?
  - Diversify, by playing 1 $ at a time?
  - Play boldly and concentrate, by playing 10,000 $ only one time?

- What is your decision criterion?
Savage’s minimal regret criterion... “Had I known”

\[
\min_{\text{Pol} \in \mathcal{U}^{ad}} \left\{ \max_{w(\cdot) \in \Omega} \left[ \max_{\text{anticipative policies}} \text{Payoff}(\text{Pol}, w(\cdot)) - \text{Payoff}(\text{Pol}, w(\cdot)) \right] \right\}
\]

- If the DM knows the future in advance, she solves
  \[
  \max_{\text{anticipative policies}} \text{Payoff}(\text{Pol}, w(\cdot)), \text{ for each scenario } w(\cdot) \in \Omega
  \]
- The regret attached to a non-anticipative policy \( \text{Pol} \in \mathcal{U}^{ad} \) is the loss due to not being visionary
- The best a non-visionary DM can do with respect to regret is minimizing it
Summary

- A criterion attaches a value to a history and performs an aggregation with respect to time, reflecting preferences across time.
- Off-line information on scenarios allows different aggregations with respect to uncertainties, reflecting risk attitudes and preferences across scenarios.
- Policies are compared with respect to both time and uncertainties payoffs aggregations.
- How do we compute optimal policies?
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Maximizing the expected additive payoff

- The expected additive payoff is \( \max_{\text{Pol} \in \mathcal{U}} \mathbb{E} \left[ \text{Payoff}(\text{Pol}, w(\cdot)) \right] \) where

\[
\text{Crit}(x(\cdot), u(\cdot), w(\cdot)) = \sum_{t=t_0}^{T-1} \text{instantaneous gain} L(t, x(t), u(t), w(t)) + K(x(T), w(T)) + \text{final gain}
\]

- The optimization problem is traditionally written as

\[
\max_{u(\cdot)} \mathbb{E} \left[ \sum_{t=t_0}^{T-1} L(t, x(t), u(t), w(t)) + K(x(T), w(T)) \right]
\]

where the last expression is abusively used, but practical and traditional,

in which \( x(\cdot) \) and \( u(\cdot) \) need to be replaced by

\[
x(t) = X_{\text{Dyn}}[t_0, x_0, \text{Pol}, w(\cdot)](t) \quad \text{and} \quad u(t) = \text{Pol}(t, x(t))
\]
The shortest path on a graph illustrates Bellman’s Principle of Optimality

For an auto travel analogy, suppose that the fastest route from Los Angeles to Boston passes through Chicago. The principle of optimality translates to obvious fact that the Chicago to Boston portion of the route is also the fastest route for a trip that starts from Chicago and ends in Boston. (Dimitri P. Bertsekas)
Bellman’s Principle of Optimality

An optimal policy has the property that whatever the initial state and initial decision are, the remaining decisions must constitute an optimal policy with regard to the state resulting from the first decision (Richard Bellman)

Richard Ernest Bellman
(August 26, 1920 – March 19, 1984)
The primitive random variables are supposed to be independent

- The set \( \Omega = \mathbb{W}^{T+1-t_0} = \mathbb{R}^q \times \cdots \times \mathbb{R}^q \) of scenarios is equipped with
  - a \( \sigma \)-field \( \mathcal{F} = \bigotimes_{t=t_0}^{T} \mathcal{B}(\mathbb{R}^q) \)
  - and a probability \( \mathbb{P} \), supposed to be of product form
    \[
    \mathbb{P} = \mu_{t_0} \otimes \cdots \otimes \mu_T
    \]
- Therefore, the primitive random variables
  \[ w(t_0), w(t_0 + 1), \ldots, w(T - 1), w(T) \]
  are independent under \( \mathbb{P} \), with marginal distributions \( \mu_{t_0}, \ldots, \mu_T \)
- The notation \( \mathbb{E} \) refers to the mathematical expectation over \( \Omega \)
  - either under probability \( \mathbb{P} \), as in \( \mathbb{E}, \mathbb{E}_{w(\cdot)}, \mathbb{E}_{\mathbb{P}} \)
  - or under the marginal distributions \( \mu_{t_0}, \ldots, \mu_T \), as in \( \mathbb{E}, \mathbb{E}_{w(t)}, \mathbb{E}_{\mu_t} \)
Delineating state and noise is a modelling issue

When the uncertainties are not independent, a solution is to enlarge the state

- If the water inflows follow an auto-regressive model, we have

\[
\begin{align*}
S(t + 1) &= \min\{S^#, S(t) - q(t) + a(t)\} \\
a(t + 1) &= \alpha a(t) + w(t)
\end{align*}
\]

where \((w(t_0), \ldots, w(T - 1))\) form a sequence of independent random variables

- The couple \(x(t) = (S(t), a(t))\) is a sufficient summary of past controls and uncertainties to do forecasting:

  knowing the state \(x(t) = (S(t), a(t))\) at time \(t\) is sufficient to forecast \(x(t + 1)\), given the control \(q(t)\) and the uncertainty \(w(t)\)
What is a state?

Bellman autobiography, Eye of the Hurricane

Conversely, once it was realized that the concept of policy was fundamental in control theory, the mathematicization of the basic engineering concept of 'feedback control,' then the emphasis upon a state variable formulation became natural.

- A state in optimal stochastic control problems is a sufficient statistics for the uncertainties and past controls (P. Whittle, Optimization over Time: Dynamic Programming and Stochastic Control)
- Quoting Whittle, suppose there is a variable $x_t$ which summarizes past history in that, given $t$ and the value of $x_t$, one can calculate the optimal $u_t$ and also $x_{t+1}$ without knowledge of the history $(\omega, u_0, ..., u_{t-1})$, for all $t$, where $\omega$ represents all uncertainties. Such a variable is termed sufficient
- While history takes value in an increasing space as $t$ increases, a sufficient variable taking values in a space independent of $t$ is called a state variable
The payoff-to-go / value function / Bellman function

Assume that the primitive random variables 
\((w(t_0), w(t_0 + 1), \ldots, w(T - 1), w(T))\) are independent under the probability \(\mathbb{P}\). The payoff-to-go from state \(x\) at time \(t\) is

\[
V(t, x) := \max_{\text{Pol} \in \mathcal{U}_{\text{ad}}} \mathbb{E} \left[ \sum_{s=t}^{T-1} L(s, x(s), u(s), w(s)) + K(x(T), w(T)) \right]
\]

where \(x(t) = x\) and, for \(s = t, \ldots, T - 1\), 
\(x(s + 1) = \text{Dyn}(s, x(s), u(s), w(s))\) and \(u(s) = \text{Pol}(s, x(s))\)

- The function \(V\) is called the value function, or the Bellman function
- The original problem is \(V(t_0, x_0)\)
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The stochastic dynamic programming equation, or Bellman equation, is a backward equation satisfied by the value function. 

Stochastic dynamic programming equation

If the primitive random variables \((w(t_0), w(t_0 + 1), \ldots, w(T - 1), w(T))\) are independent under the probability \(\mathbb{P}\), the value function \(V(t, x)\) associated with the additive criterion satisfies the following backward induction, where \(t\) runs from \(T - 1\) down to \(t_0\)

\[
V(T, x) = \mathbb{E}_{w(T)} \left[ K(x, w(T)) \right]
\]

\[
V(t, x) = \max_{u \in B(t, x)} \mathbb{E}_{w(t)} \left[ L(t, x, u, w(t)) + V(t + 1, \text{Dyn}(t, x, u, w(t))) \right]
\]
Algorithm for the Bellman functions

\[
\begin{align*}
\text{Initialization } & V(T, x) = \sum_{w \in S(t)} P\{w\} K(x, w); \\
\text{for } t = T, T - 1, \ldots, t_0 \text{ do } & \\
& \quad \text{forall the } x \in X \text{ do } \\
& \quad \quad \text{forall the } u \in B(t, x) \text{ do } \\
& \quad \quad \quad \text{forall the } w \in S(t) \text{ do } \\
& \quad \quad \quad \quad l(t, x, u, w) = L(t, x, u, w) + V(t + 1, \text{Dyn}(t, x, u, w)) \\
& \quad \quad \quad \sum_{w \in S(t)} P\{w\} l(t, x, u, w) \\
&amp; V(t, x) = \max_{u \in B(t, x)} \sum_{w \in S(t)} P\{w\} l(t, x, u, w); \\
B^*(t, x) = \argmax_{u \in B(t, x)} \sum_{w \in S(t)} P\{w\} l(t, x, u, w)
\end{align*}
\]
Sketch of the proof in the deterministic case

\[ V(t, x) = \max_{u \in B(t, x)} \left( \text{instantaneous gain} \left( L(t, x, u) \right) + \text{optimal payoff} \left( V(t + 1, \text{Dyn}(t, x, u)) \right) \right) \]

A decision \( u \) at time \( t \) in state \( x \) provides
- an instantaneous gain \( L(t, x, u) \)
- and a future payoff for attaining the new state \( \text{Dyn}(t, x, u) \)
The Bellman equation provides an optimal policy

Proposition

For any time $t$ and state $x$, assume the existence of the policy $\text{Pol}^*(t, x) \in \arg\max_{u \in \mathcal{B}(t, x)} \mathbb{E}_{w(t)} \left[ L(t, x, u, w(t)) + V(t + 1, \text{Dyn}(t, x, u, w(t))) \right]$

If $\text{Pol}^*: (t, x) \mapsto \text{Pol}^*(t, x)$ is measurable, then

- $\text{Pol}^*$ is an optimal policy
- for any initial state $x_0$, the optimal expected payoff is given by

$$V(t_0, x_0) = \max_{\text{Pol} \in \mathcal{U}_{ad}} \text{Crit}_{\text{expect}}^{\text{Pol}}(t_0, x_0) = \text{Crit}_{\text{expect}}^{\text{Pol}^*}(t_0, x_0)$$
“Where did the name, dynamic programming, come from?”

The 1950s were not good years for mathematical research. We had a very interesting gentleman in Washington named Wilson. He was Secretary of Defense, and he actually had a pathological fear and hatred of the word, research. I’m not using the term lightly; I’m using it precisely. His face would suffuse, he would turn red, and he would get violent if people used the term, research, in his presence. You can imagine how he felt, then, about the term, mathematical.
“Where did the name, dynamic programming, come from?”

What title, what name, could I choose? In the first place I was interested in planning, in decision making, in thinking. But planning, is not a good word for various reasons. I decided therefore to use the word, programming. I wanted to get across the idea that this was dynamic, this was multistage, this was time-varying. I thought, let’s kill two birds with one stone. Let’s take a word that has an absolutely precise meaning, namely dynamic, in the classical physical sense. It also has a very interesting property as an adjective, and that is it’s impossible to use the word, dynamic, in a pejorative sense. Try thinking of some combination that will possibly give it a pejorative meaning. It’s impossible. Thus, I thought dynamic programming was a good name.
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Optimal trajectories are calculated forward on-line

1. Initial state $x^*(t_0) = x_0$
2. Plug the state $x^*(t_0)$ into the “machine” $\text{Pol} \rightarrow \text{initial decision}$
   $u^*(t_0) = \text{Pol}^*(t_0, x^*(t_0))$
3. Run the dynamics $\rightarrow$ second state $x^*(t_0 + 1) = \text{Dyn}(t_0, x^*(t_0), u^*(t_0), w(t_0))$
4. Second decision $u^*(t_0 + 1) = \text{Pol}^*(t_0 + 1, x^*(t_0 + 1))$
5. And so on $x^*(t_0 + 2) = \text{Dyn}(t_0 + 1, x^*(t_0 + 1), u^*(t_0 + 1)), w(t_0 + 1)$
6. ...
“Life is lived forward but understood backward”
(Søren Kierkegaard)

D. P. Bertsekas introduces his book *Dynamic Programming and Optimal Control* with a citation by Søren Kierkegaard

”*Livet skal forstås baglaens, men leves forlaens*”

*Life is to be understood backwards, but it is lived forwards*

- The value function and the optimal policies are computed backward and *offline* by means of the Bellman equation
- whereas the optimal trajectories are computed forward and *online*
The curse of dimensionality is illustrated by the random access memory capacity on a computer: one, two, three, infinity (Gamov)

- On a computer
  - RAM: 8 GBytes = \(8(1024)^3 = 2^{33}\) bytes
  - a double-precision real: 8 bytes = \(2^3\) bytes
  - \(2^{30} \approx 10^9\) double-precision reals can be handled in RAM

- If a state of dimension 4 is approximated by a grid with 100 levels by components, we need to manipulate \(100^4 = 10^8\) reals and
  - do a time loop
  - do a control loop (after discretization)
  - compute an expectation

The wall of dimension can be pushed beyond 3 if additional properties are exploited (linearity, convexity)
Summary

- Bellman’s Principle of Optimality breaks an intertemporal optimization problem into a sequence of interconnected static optimization problems.
- The payoff-to-go / value function / Bellman function is solution of a backward dynamic programming equation, or Bellman equation.
- The Bellman equation provides an optimal policy, a concept of solution adapted to uncertain case.
- In practice, the curse of dimensionality forbids to use dynamic programming for a state with dimension more than three or four.
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Bellman equation and optimal policies in the hazard-decision information pattern

The uncertainty is observed before making the decision

\[
V(T, x) = \sum_{w \in S(t)} P\{w\} K(x, w);
\]

\[
\text{for } t = T, T - 1, \ldots, t_0 \text{ do}
\]

\[
\text{forall the } x \in X \text{ do}
\]

\[
\text{forall the } w \in S(t) \text{ do}
\]

\[
\text{forall the } u \in B(t, x) \text{ do}
\]

\[
l(t, x, u, w) = L(t, x, u, w) + V(t + 1, \text{Dyn}(t, x, u, w))
\]

\[
\max_{u \in B(t, x)} l(t, x, u, w);
\]

\[
B^*(t, x, w) = \arg \max_{u \in B(t, x)} l(t, x, u, w)
\]

\[
V(t, x) = \sum_{w \in S(t)} P\{w\} \max_{u \in B(t, x)} l(t, x, u, w)
\]
In the linear-quadratic-Gaussian case, optimal policies are linear

- When utilities are quadratic
  
  $$K(x, w) = x' S_T x + w' R_T w$$
  
  $$L(t, x, u, w) = x' S_t x + w' R_t w + u' Q_t u$$

- and the dynamic is linear
  
  $$Dyn(t, x, u, w) = F_t x + G_t u + H_t w$$

- and primitive random variables \((w(t_0), w(t_0 + 1), \ldots, w(T - 1), w(T))\) are Gaussian independent under the probability \(\mathbb{P}\)

- then, the value functions \(x \mapsto V(t, x)\) are quadratic, and optimal policies are linear

  $$u(t) = K_t x(t)$$
In the linear-convex case, value functions are convex

Here, we aim at minimizing expected cumulated costs

$$\mathbb{E}\left[ \sum_{t=t_0}^{T-1} \text{Cost}(t, x(t), u(t), w(t)) + \text{CostFin}(x(T), w(T)) \right]$$

The value functions $x \mapsto V(t, x)$ are convex whenever

- $(x, u) \mapsto \text{Cost}(t, x, u, w)$ is jointly convex in state and control
- $x \mapsto \text{CostFin}(x, w)$ is convex
- $w(t), \ldots, w(T)$ are independent random variables
- the dynamic is linear

$$\text{Dyn}(t, x, u, w) = F_t x + G_t u + H_t w$$
The minimum over one variable of a jointly convex function is convex in the other variable

A lemma in convex analysis

Let $f : Y \times Z \rightarrow \mathbb{R}$ be convex, and let $C \subset Y \times Z$ be a convex set. Then

$$g(y) = \min_{z \in Z, (y, z) \in C} f(y, z)$$

is a convex function
The Bellman equation produces convex value functions

- The dynamic programming equation associated with the problem of minimizing the expected costs is

\[
V(T, x) = \mathbb{E}_{w(T)} \left[ \text{CostFin}(x, w(T)) \right]
\]

\[
V(t, x) = \min_{u \in B(t, x)} \mathbb{E}_{w(t)} \left[ \text{Cost}(t, x, u, w(t)) \right] + V(t + 1, \text{Dyn}(t, x, u, w(t)))
\]

- It can be shown by induction that \( x \mapsto V(t, x) \) is convex
- The derivative \( \frac{\partial V}{\partial x} \) at \((t + 1, x^*(t + 1))\) defines a hyperplane and a lower affine approximation of the value function, calculated by duality
Computing optimal decisions on-line

- If we are able to store the value functions $x \mapsto V(t, x)$,
- we do not need to compute the optimal policy $Pol^*$ in advance and store it,
- but, when we are at state $x$ at time $t$ in real time,
  we can just compute the optimal decision $u^*(t)$ “on the fly” by

$$
u^*(t) \in \arg\max_{u \in B(t, x)} E_w(t) \left[ L(t, x, u, w(t)) + V(t + 1, Dyn(t, x, u, w(t))) \right]$$

- Thus, the effort can be concentrated on computing the value functions
  on a grid, by discretizing the Bellman equation
  by estimating basis coefficients,
  when it is known that the value function is quadratic
  by estimating upper affine approximation of the value function,
  when it is known that the value function is concave
  by estimating lower approximation of the value function,
  when restricting the search to a subclass of policies (open-loop in OLFO)
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Plants display a large spectrum of life-history patterns

(Mark Kot, *Elements of Mathematical Ecology*)

- Herbs often flower in their first year and then die, roots and all, after setting seed
- Plants that flower once and then die are *monocarpic*
  - Bamboos are grasses but they grow to unusually large size. One Japanese species, *Phyllostachys bambusoides*, waits 120 years to flower (Janzen, 1976)
  - Most trees flower repeatedly. However, Foster (1977) has characterized *Tachigalia versicolor* as a 'suicidal neotropical tree'. After reaching heights of 30-40 m, it flowers once and then dies
A stochastic control model of plant growth

The model is a discrete time one with time variable \( t \in \{t_0, \ldots, T\} \)

A time unit may typically be either a day \( (t \in \{0, \ldots, 364\}) \), a month \( (t \in \{0, \ldots, 11\}) \), or a season \( (t \in \{0, 1, 2, 3\}) \)

1. At the beginning of each time interval \([t, t+1]\),
   - the plant is characterized by its vegetative biomass \( k_t \in [0, +\infty] \)
   - and by the cumulated reproductive biomass \( S_t \in [0, +\infty] \)
2. At the end of each time interval \([t, t+1]\),
   - the vegetative biomass \( k_{t+1} \) is at most \( f(k_t) \),

\[ 0 \leq k_{t+1} \leq f(k_t) \]

where \( f \) is the growth function
The growth of a plant in one period is modeled by a strictly increasing and strictly concave function.

Concerning the (gross) growth function \( f : \mathbb{R}_+ \to \mathbb{R} \), we make the following assumptions:

- \( f \) is continuous
- \( f(0) = 0 \)
- \( f(k) > 0 \) for \( k > 0 \)
- \( f \) is strictly increasing: \( f' > 0 \)
- \( f \) is strictly concave: \( f'' < 0 \)
A stochastic control model of plant growth

1. At the beginning of each time interval \([t, t + 1]\),
   - the plant is characterized by its vegetative biomass \(k_t \in [0, +\infty]\)
   - and by the cumulated reproductive biomass \(S_t \in [0, +\infty]\)

2. During each time interval \([t, t + 1]\), where \(t + 1 < T\),
   - the plant allocates biomass \(u_t\) as vegetative biomass, with \(0 \leq u_t \leq f(k_t)\)
   - and \(f(k_t) - u_t\) as reproductive biomass in the interval \([t, t + 1]\)

3. At the end of each time interval \([t, t + 1]\), where \(t + 1 < T\),
   - the cumulated reproductive biomass is
     \[S_{t+1} = S_0 + \sum_{s=0}^{t}[f(k_s) - u_s] = S_t + [f(k_t) - u_t]\]
   - the plant vegetative biomass is \(k_{t+1}\)
     - either \(k_{t+1} = u_t\) with probability \(p\) (survival)
     - or \(k_{t+1} = 0\) with probability \(1 - p\) (death)

4. At the maximal life span \(T\),
   - the cumulated reproductive biomass \(S_T\) is released
     in the form of independent offspring
Optimization problem and Bellman equation

- Which are the growth strategies $u_t = \text{Pol}(t, k_t)$, or the growth patterns $(u_{t_0}, k_{t_0}), \ldots, (u_{T-1}, k_{T-1})$ that display the highest expected offspring $\mathbb{E}[S_T]$?

- The optimization problem is

$$\max \mathbb{E} \left[ \sum_{t=t_0}^{T-1} (f(k_t) - u_t) \right]$$

- The corresponding Bellman equation is

$$V(T, k) = \begin{cases} 0 & \text{no final gain} \\ \max_{0 \leq u \leq f(k)} \left( f(k) - u + pV(t+1, u) + (1-p)V(t+1, 0) \right) & \text{offspring/death} \end{cases}$$
Optimal growth strategies and patterns

Since $f'$ is decreasing (and supposing that $f'(0) = +\infty$ and that $\lim_{k \to +\infty} f'(k) = 0$, define $k_p$ by

$$f'(k_p) = 1/p$$

In the case where $k_p \leq f(k_p)$, one can show that the optimal strategy is stationary (except for the ultimate one consisting in dying)

$$\text{Pol}^*(t, k) = \begin{cases} 
  f(k) & \text{if } k \leq f^{-1}(k_p) \\
  k_p & \text{if } k \geq f^{-1}(k_p) 
\end{cases}$$
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A biomass linear model over two periods

- We consider the biomass linear model over two periods $T = 2$

\[
B(t + 1) = R(t) \left( B(t) - h(t) \right), \quad t = 0, 1
\]

where $R(0)$ and $R(1)$ are two independent random variables representing growth factors

- We aim at maximizing the expectation of the sum of the discounted successive harvesting revenues (with discount factor $\delta = \frac{1}{1+r_e}$)

\[
\max \mathbb{E}_{R(0), R(1)} \left[ p(0)h(0) + \delta p(1)h(1) \right]
\]

- where the harvests satisfy $0 \leq h(0) \leq B(0), \ 0 \leq h(1) \leq B(1)$
- and the prices $p(0)$ and $p(1)$ are fixed
The Bellman equation (ultimate and penultimate periods)

- Since there is no final term in the criterion, we have
  \[ V(2, B) = 0 \]

- By the Bellman equation, we have
  \[
  V(1, B) = \max_{0 \leq h \leq B} \mathbb{E}_{R(1)}[\delta p(1)h + V(2, R(1)(B - h))] \\
  = \max_{0 \leq h \leq B} \mathbb{E}_{R(1)}[\delta p(1)h] \\
  = \delta p(1)B
  \]

  with a maximum achieved at
  \[ *(1, B) = B \]
The Bellman equation (initial period)

By the Bellman equation, we have

\[ V(0, B) = \max_{0 \leq h \leq B} \mathbb{E}_{R(0)}[p(0)h + V(1, R(0)(B - h))] \]

\[ = \max_{0 \leq h \leq B} \mathbb{E}_{R(0)}[p(0)h + \delta p(1)R(0)(B - h)] \]

\[ = \max_{0 \leq h \leq B} p(0)h + \delta p(1)\mathbb{E}_{R(0)}[R(0)](B - h) \]

with a maximum achieved at \( h = 0 \) or at \( h = B \) depending on the sign of \( p(0) - \delta \mathbb{E}_{R(0)}[R(0)]p(1) \)

- if \( p(0) > \delta \mathbb{E}_{R(0)}[R(0)]p(1) \), then \( *(0, B) = B \)
- if \( p(0) < \delta \mathbb{E}_{R(0)}[R(0)]p(1) \), then \( *(0, B) = 0 \)
A biomass linear model over \( T - t_0 + 1 \) periods

- The dynamic model is

\[
B(t + 1) = R(t)(B(t) - h(t)), \quad 0 \leq h(t) \leq B(t)
\]

where \( R(t_0), \ldots, R(T - 1) \) are independent and identically distributed positive random variables.

- We consider expected intertemporal discounted utility maximization

\[
\max_{h(t_0), \ldots, h(T-1)} \mathbb{E} \left[ \sum_{t=t_0}^{T-1} \delta^{t-t_0} L(h(t)) + \delta^{T-t_0} L(B(T)) \right]
\]

where we restrict the study to the isoelastic case

\[
L(h) = h^\eta \text{ with } 0 < \eta < 1
\]
The dynamic programming equation starts by

$$ V(T, B) = \delta^{T-t_0} B^n $$

and, for $t = t_0, \ldots, T - 1$, gives

$$ V(t, B) = \max_{h \in [0, B]} (\delta^{t-t_0} h^n + \mathbb{E}_R [V(t+1, R(B-h))]) $$

where $R$ is a random variable standing for the uncertain growth of the resource and having the same distribution as any of the random variables $R(t_0), \ldots, R(T-1)$
Optimal policy

• The value function $V(t, B)$ is given by

$$V(t, B) = \delta^{t-t_0} b(t)^{\eta-1} B^\eta$$

• and the optimal policy is

$$^*(t, B) = b(t) B$$

• where the optimal fraction satisfies

$$\frac{1}{b(t)} = 1 + \frac{1}{a} + \cdots + \frac{1}{a^{T-t}} \quad \text{with} \quad a = (\delta \hat{R}^\eta)^{\frac{1}{\eta-1}}$$

where the certainty equivalent $\hat{R}$ is defined by the implicit equation

$$L(\hat{R}) = E_R[L(R)]$$
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Inventory control dynamical model

Consider the control dynamical model

$$x(t + 1) = x(t) + u(t) - w(t)$$

- time $t \in \{t_0, \ldots, T\}$ is discrete (days, weeks or months, etc.)
- $x(t)$ is the stock at the beginning of period $t$, belonging to $X = \mathbb{Z} = \{\ldots, -2, -1, 0, 1, 2, \ldots\}$
- $u(t)$ is the stock ordered at the beginning of period $t$, belonging to $U = \mathbb{N} = \{0, 1, 2, \ldots\}$
- $w(t)$ is the uncertain demand during the period $t$, belonging to $W = \mathbb{N} = \{0, 1, 2, \ldots\}$

When $x(t) < 0$, this corresponds to a backlogged demand, supposed to be filled immediately once inventory is again available.
Inventory optimization criterion

- The costs incurred in period $t$ are:
  - purchasing costs: $cu(t)$
  - shortage costs: $b \max \{0, -(x(t) + u(t) - w(t))\}$
  - holding costs: $h \max \{0, x(t) + u(t) - w(t)\}$

- On the period from $t_0$ to $T$, the costs sum up to:

$$
\sum_{t=t_0}^{T-1} [cu(t) + b \max \{0, -(x(t) + u(t) - w(t))\} + h \max \{0, x(t) + u(t) - w(t)\}]
$$
Probabilistic assumptions and the inventory stochastic optimization problem

- We suppose that:
  - $w(t)$, the uncertain demand, is a random variable with distribution $p_0, \ldots, p_N$ on the set $\{0, \ldots, N\}$
  - the sequence of demands $w(t_0), \ldots, w(T - 1)$ is independent

- We consider the inventory stochastic optimization problem

$$\min_{u(\cdot)} \mathbb{E} \left[ \sum_{t=t_0}^{T-1} \left[ cu(t) + \text{Cost}(x(t) + u(t) - w(t)) \right] \right]$$
The Bellman equation

The dynamic programming equation associated with the problem of minimizing the expected costs is

\[
V(T, x) = \begin{cases} 
\text{final cost} & 0 \\
V(t, x) = \min_{u=0,1,...} \mathbb{E}_W \left[ cu + \text{Cost}(x + u - W) + V(t + 1, x + u - W) \right] & \text{instantaneous cost}
\end{cases}
\]

where

- \( W \) is a random variable with the distribution \( p_0, \ldots, p_N \) on the set \( \{0, \ldots, N\} \)
- the cost function is the piecewise linear function

\[
\text{Cost}(x) = b \max\{0, -x\} + h \max\{0, x\}
\]
The value function is convex in the state

\[ V(T-1, x) = \min_{u=0,1...} \mathbb{E}[cu + \text{Cost}(x + u - W)] = \min_{u=0,1...} [cu + \sum_{i=0}^{N} p_i \text{Cost}(x + u - i)] \]

Recalling that \( b > c > 0 \), show that 
\[ z \mapsto \mathbb{E}[cz + \text{Cost}(z - W)] \] is a convex function with a minimum \( x_{T-1} \)
The optimal policy is an echelon base-stock policy

Deduce that an optimal policy is

\[
\text{Pol}(T - 1, x) = \begin{cases} 
\overline{x}_{T-1} - x & \text{if } x < \overline{x}_{T-1} \\
0 & \text{if } x \geq \overline{x}_{T-1}
\end{cases}
\]

Show by induction that there exist thresholds (echelons) \( \overline{x}_0, \ldots, \overline{x}_{T-1} \) such that the optimal policy at period \( t \) is

\[
\text{Pol}(t, x) = \begin{cases} 
\overline{x}_t - x & \text{if } x < \overline{x}_t \\
0 & \text{if } x \geq \overline{x}_t
\end{cases}
\]

Interpret this policy
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When turbinating decisions are made after knowing the water inflows, we obtain a linear dynamical model

We can model the dynamics of the water volume in a dam by

\[
S(t + 1) = S(t) - q(t) - r(t) + a(t)
\]

- **\( S(t) \)** volume (stock) of water at the beginning of period \([t, t + 1]\)
- **\( a(t) \)**, inflow water volume (rain, etc.) during \([t, t + 1]\);
- hazard-decision:
  - **\( a(t) \)** is known and available at the beginning of period \([t, t + 1]\)
  - **\( q(t) \)** turbined outflow volume and **\( r(t) \)** spilled volume
    - decided at the beginning of period \([t, t + 1]\)
    - supposed to depend on the stock \( S(t) \) and on the inflow water \( a(t) \)
    - chosen such that

\[
0 \leq q(t) \leq \min\{S(t), q^\#\} \quad \text{and} \quad 0 \leq S(t) - q(t) + a(t) - r(t) \leq S^\#
\]
We aim at minimizing cumulated convex costs

On the period from \( t_0 \) to \( T \), the costs sum up to

\[
\sum_{t=t_0}^{T-1} \text{instantaneous cost} + \text{final cost}
\]

\[
\sum_{t=t_0}^{T-1} \text{Cost}(t, S(t), q(t), a(t)) + \text{CostFin}(T, S(T), a(T))
\]

where

- \((S, q) \mapsto \text{Cost}(t, S, q, a)\) is jointly convex in state and control
- \(S \mapsto \text{CostFin}(T, S, a)\) is convex
- \(a(t), \ldots, a(T)\) are independent random variables
The Bellman equation produces convex value functions

The dynamic programming equation associated with the problem of minimizing the expected costs is

\[
V(T, S) = \mathbb{E}_{a(T)} \left[ \text{CostFin}(T, S, a(T)) \right]
\]

\[
V(t, S) = \mathbb{E}_{a(t)} \left[ \min_{0 \leq q \leq \min\{S, q^\#\}, r \geq 0, 0 \leq S - q + a(t) - r \leq S^\#} \text{Cost}(t, S, q, a(t)) + V(t + 1, S - q - r + a(t)) \right]
\]

and it can be shown by induction that \( S \mapsto V(t, S) \) is convex

The derivative \( \frac{\partial V}{\partial S} \) at \((t + 1, S^*(t + 1))\) defines a hyperplane and a lower approximation of the value function, calculated by duality.
The property that value functions are convex extends to the following cases:

- Multiple stocks interconnected by linear dynamics:
  \[ S_i(t + 1) = S_i(t) + a_i(t) + q_{i-1}(t) - q_i(t) - r_i(t) \]

- Water inflows following an auto-regressive model:
  \[ a_i(t) = \sum_{k=1,...,K_i} \alpha_k a_i(t - k) + w(t) \]
  where \( w(t_0), \ldots, w(T) \) are independent random variables.
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6. Summary
Maximal worst payoff

- First, we fix an admissible decision rule $Pol$. 
- Then, we introduce the worst performance, namely the minimal payoff with respect to the scenarios $w(\cdot) \in \overline{\Omega} \subset \Omega$:
  \[
  \text{Crit}_{\text{worst}}^{Pol}(t_0, x_0) := \min_{w(\cdot) \in \overline{\Omega}} \text{Crit}^{Pol}(t_0, x_0, w(\cdot))
  \]

- Second, we let the decision rule $Pol$ vary, and aim at maximizing this worst payoff by solving the optimization problem
  \[
  \max_{Pol \in U^{ad}} \text{Crit}_{\text{worst}}^{Pol}(t_0, x_0) = \max_{u(\cdot)} \min_{w(\cdot) \in \overline{\Omega}} \text{Crit}(x(\cdot), u(\cdot), w(\cdot))
  \]

where the last expression is abusively used, but practical and traditional, in which $x(\cdot)$ and $u(\cdot)$ need to be replaced by
\[
  x(t) = X_{\text{Dyn}}[t_0, x_0, Pol, w(\cdot)](t) \quad \text{and} \quad u(t) = Pol(t, x(t))
\]
Robust additive dynamic programming equation

\[
\text{Crit}(x(\cdot), u(\cdot), w(\cdot)) = \sum_{t=t_0}^{T-1} \text{instantaneous gain} \{ L(t, x(t), u(t), w(t)) \} + \text{final gain} \{ K(x(T), w(T)) \}
\]

Proposition

If the scenarios vary within a rectangle \( \overline{\Omega} = S(t_0) \times \cdots \times S(T) \) (corresponding to independence in the stochastic setting), the value functions \( V(t, x) \) satisfy the following backward induction, where \( t \) runs from \( T - 1 \) down to \( t_0 \)

\[
V(T, x) = \min_{w \in S(T)} K(x, w)
\]

\[
V(t, x) = \max_{u \in B(t, x)} \min_{w \in S(t)} \left[ L(t, x, u, w) + V(t + 1, \text{Dyn}(t, x, u, w)) \right]
\]
Proposition

For any time $t$ and state $x$, assume the existence of the following policy

$$\text{Pol}^*(t, x) \in \arg\max_{u \in \mathcal{B}(t, x)} \min_{w \in \mathcal{S}(t)} \left[ L(t, x, u, w) + V(t + 1, \text{Dyn}(t, x, u, w)) \right]$$

Then $\text{Pol}^* \in \mathcal{U}$ is an optimal policy of the robust problem and, for any initial state $x_0$, the maximal worst payoff is given by

$$V(t_0, x_0) = \max_{\text{Pol} \in \mathcal{U}_{\text{ad}}} \text{Crit}_{\text{worst}}^{\text{Pol}}(t_0, x_0) = \text{Crit}_{\text{worst}}^{\text{Pol}^*}(t_0, x_0)$$
A biomass linear model over two periods

- The uncertain resource productivity $R(t) \in \mathbb{S}(t) = [R^b, R^\#] \subset \mathbb{W} = \mathbb{R}$, with $R^b < R^\#$

- We aim at maximizing the worst benefit namely the minimal sum of the discounted successive harvesting revenues

$$\max_{0 \leq h(0) \leq B(0), \, 0 \leq h(1) \leq B(1)} \min_{R(0), R(1)} \left[ ph(0) + \delta ph(1) \right]$$

where the resource dynamics is

$$B(1) = R(0)(B(0) - h(0)), \quad B(2) = R(1)(B(1) - h(1))$$
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6. Summary
• Time-additive criteria are well adapted to dynamic programming in robust and stochastic optimization problems (but other criteria also work well)
• Bellman’s Principle of Optimality breaks an intertemporal optimization problem into a sequence of interconnected static optimization problems
• In practice, the curse of dimensionality forbids to use dynamic programming for a state with dimension more than three or four