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TODAY'S SEMINAR:
THE ART OF DECISION MAKING
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UH, OH...

Decision Theory
and
Decision Analysis

Denis Bouyssou

CNRS — LAMSADE

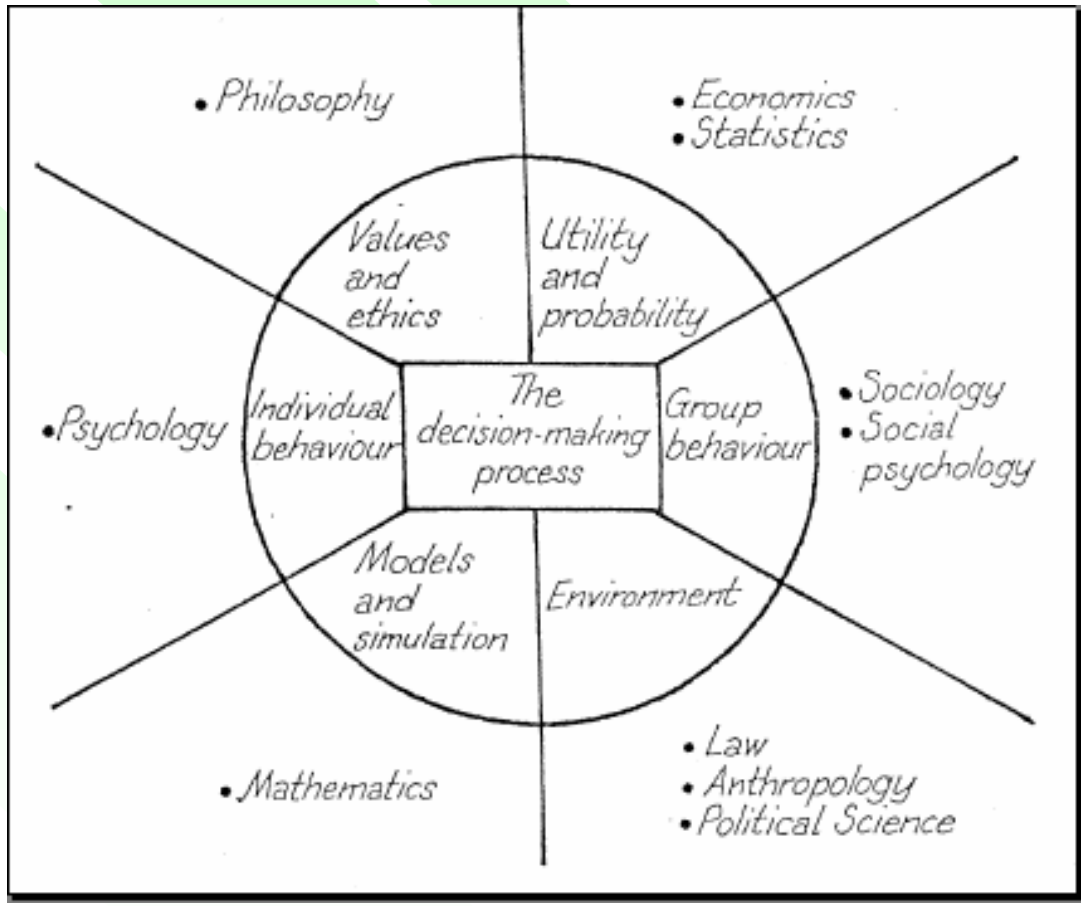
Aims of the lecture

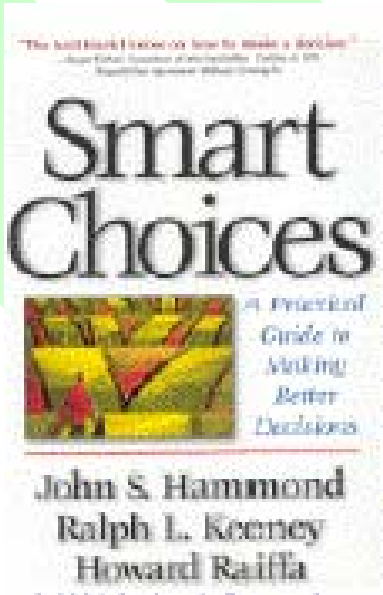
- "Decision"
  - Many different types
  - Many different techniques

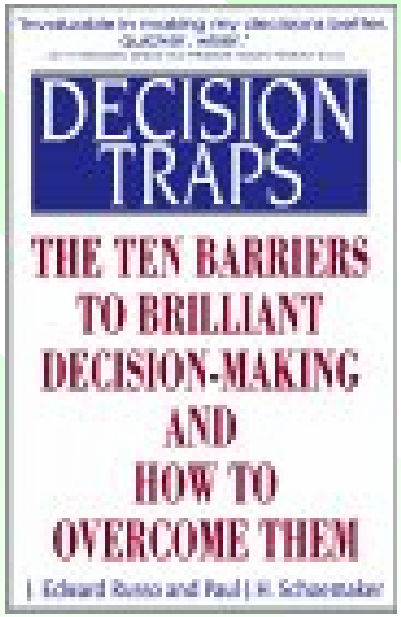
- Give a general framework for thinking about decision problems
- Put the various decision analysis techniques in perspective
- Show the *links* between decision analysis and decision theory

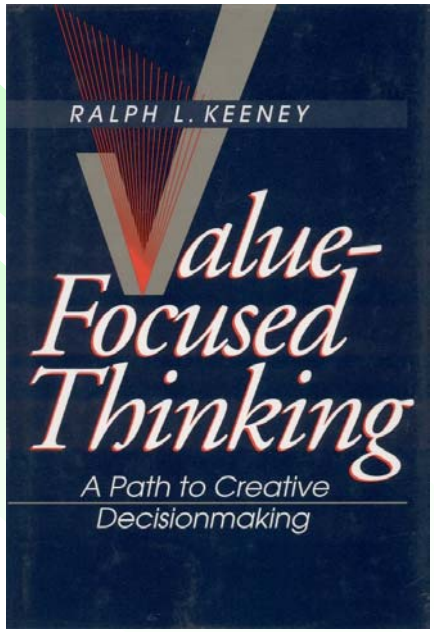
Decision

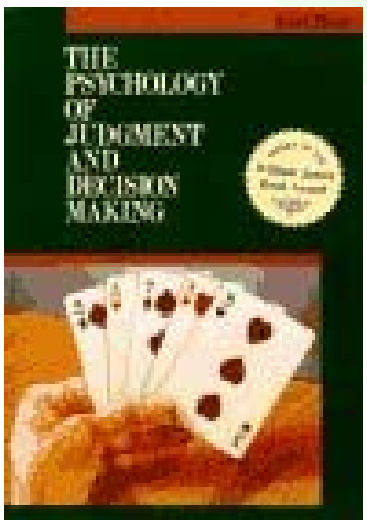
- Philosophy
- Economics
- Psychology
- Sociology
- Political Science
- Computer Science
- Operational Research
- Biology?
- Theology?

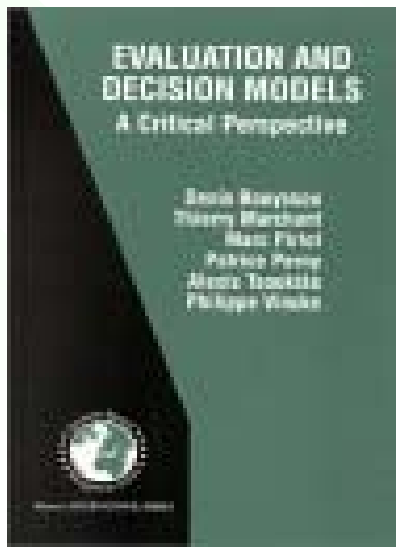



Smart Choices
A Practical Guide to Making Better Decisions
John S. Hammond
Ralph L. Keeney
Howard Raiffa


DECISION TRAPS
THE TEN BARRIERS TO BRILLIANT DECISION-MAKING AND HOW TO OVERCOME THEM

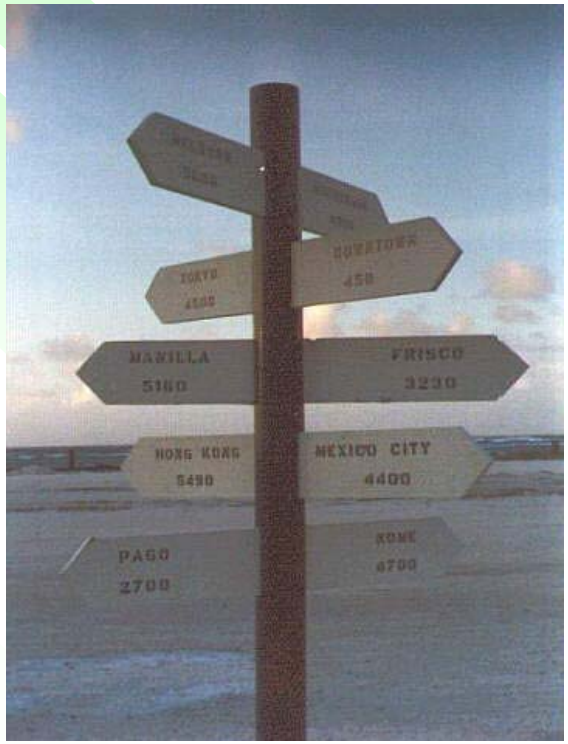

RALPH L. KEENEY
Value-Focused Thinking
A Path to Creative Decisionmaking


THE PSYCHOLOGY OF JUDGMENT AND DECISION MAKING


EVALUATION AND DECISION MODELS
A Critical Perspective

Outline

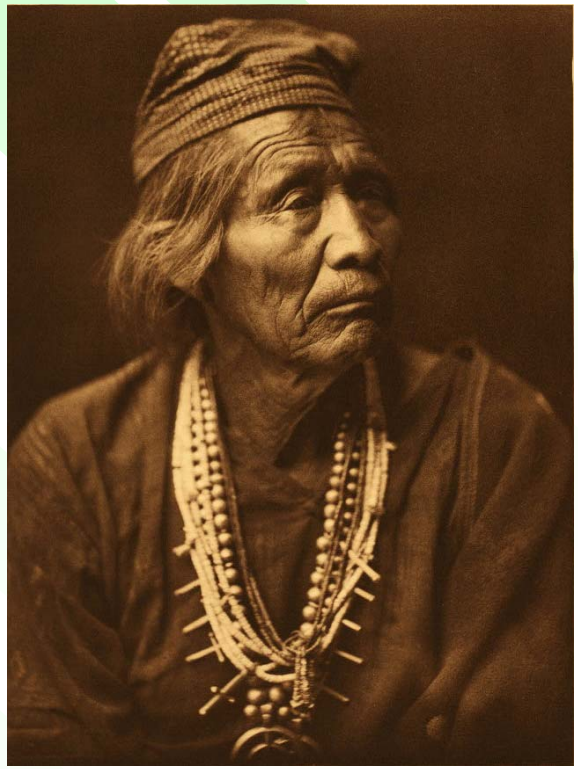
- Classical view on decision
- Another view
- What can be expected?
- What should we take care of?
- What are the main types of models?



Decision ?

- Classical view (Catastrophe, Bifurcation)
  - free individual freely choosing between several courses of action
- Culturally biased view
- Philosophic difficulties
- Organization sociology, Organizational Behavior
  - Agendas of CEO and “high level executives”
  - H. Mintzberg “myths and realities”
    - The Nature of Managerial Work, Harper and Row, 1973

Difficulties with the classical view



Managers

- 160 managers UK
  - 1 period every two days in which they work continuously on the same subject for 30 minutes
  - 1 verbal contact in 398 deals with organization / planning
  - on average 583 different activities within 8 hours
    - 0,82 min per activity

Mintzberg's Studies of Managers

- **Myth #1**: The manager is a reflective systematic planner.
  - **Fact**: Study after study shows managers work at an unrelenting pace, that their activities are characterized by brevity, variety, and discontinuity, they are strongly oriented toward action, and dislike reflective activities.
- **Myth #2**: The effective manager has no regular duties to perform.
  - **Fact**: Managerial work involves performing a number of regular duties, including ritual and ceremony, negotiations, and processing of soft information that links the organization with its environment

Mintzberg's Studies of Managers

- **Myth #3**: The senior manager needs aggregated information, which a formal management information system best provides.
  - Fact: Managers strongly favor verbal media, telephone calls, and meetings over documents.

Myth #4: Management is, or at least is quickly becoming, a science and a profession.

- **Fact**: The managers' programs - to schedule time, process information, make decisions, and so on - remain locked deep inside their brains.

France (CEOs)

- 15 % transports
- 5 % visits
- 5 % individuals interviews
- 30 % internal meetings
- 10 % external meetings
- 10 % meals
- 15 % telephone
- 5 % reading / writing mail
- 2 % writing
- 2 % reading
- 1 % solitary reflection (6 min./j)
- 0 % computers

20 %

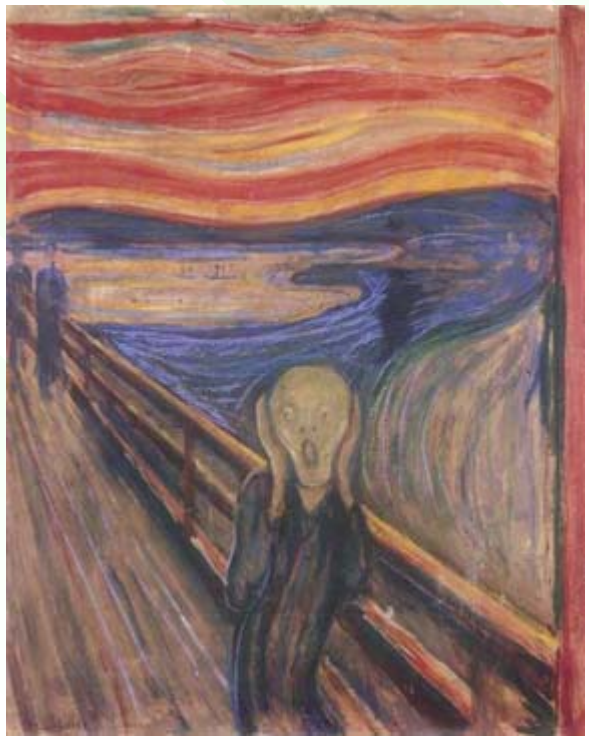
55 %

25 %

Decision

- ***Provisional definition*** **[R. Howard]: "Decision-making is what you do when you do not know what to do"**
- **Criteria: Anxiety, Fear, Hyper-vigilance**
- **Symptoms**
  - **Scribbling on a sheet of paper / worksheet**
  - **Multiplication of meetings**
  - **Procrastination**
  - **Depression phases / Enthusiasm Phases**
- **Complexity**
  - **High / complex stakes**
  - **Uncertainty / Time horizon / Multiples objectives**

Real Decisions



Three classical attitudes

- **Omen**
  - **Intuition / Charismatic leader / Expert / Authority**
- **Ritual Sacrifices**
  - **René Girard "Things Hidden Since the Foundation of the World", "The Scapegoat"**
- **Consulting study**

KPMG

Deloitte Touche Tohmatsu

Let someone else carry your anxiety

Decision Analytic tools = Tools for managing anxiety

What Decision Analysis is not!

- **A general method for taking "good decisions"**

  Example

  - **Choice 1: [Heads] 1000 € [Tails] 0 €**
  - **Choice 2: [Heads Heads] 5000 € [Otherwise] 0 €**

  Example

  - **Choice of new job, medical decision, etc.**

- **What is a "good decision"?**
  - **Good for whom, according to what criteria, at which moment in time?**
- **Good decision processes *vs.* good decisions**
  - **Japanese shoemaker**

What Decision Analysis is not!

- A description on how “wise people” decide
  - Expert systems
  - Doctors / Politicians
    - Prevention vs.. First Aid
    - Nuclear Industry vs.. Road safety
      - ⇦ 5 000 000 vs.. 140 000 (USD 1978)
- How do you recognize “wise people”?
  - Luck vs. Wisdom
- What can we do then?

Example: rolling a dice

	1	2	3	4	5	6
a	0	100	200	300	400	500
b	100	200	300	400	500	0

	1	2	3	4	5	6
a	10	110	210	310	410	510
b	100	200	300	400	500	0

Preference cycle

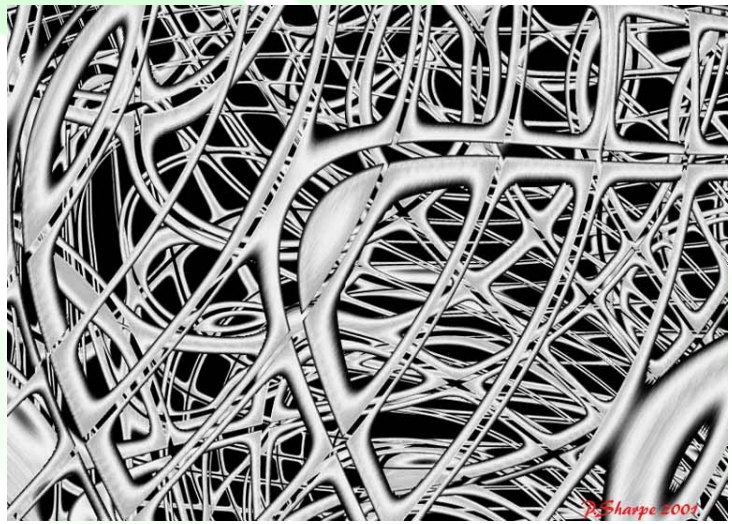
	1	2	3	4	5	6
a	0	100	200	300	400	500
b	100	200	300	400	500	0
c	200	300	400	500	0	100
d	300	400	500	0	100	200
e	400	500	0	100	200	300
f	500	0	100	200	300	400
a	0	100	200	300	400	500

Decision Analysis

- **Definition (B. Roy): "consists in trying to provide *answers* to questions raised by actors involved in a *decision process* using a *model*"**
- ***Decision process*: strategy of intervention: aid, communication, justification, etc.**
  - **Many different ways to provide decision-aid**
  - **Difficulty to compare methods**
    - **What is a "good" DA model ?**
  - **Different models may lead to different recommendations**

Decision Process

- Time
- Multiple actors
- Organization
  - links with other processes
  - power
- Milestones
  - alternatives created / rejected
  - fragments of decisions



Decision Making

- Decision Making ≠ "Solving" a well-defined problem
- Intervention in a decision process
  - imagine compromises
  - communicate
  - coordinate
  - control
  - motivate
  - conduct change
- Importance of "final choice"?

Decision analytic tools

- *Ex ante* usage
  - providing hindsight / answer
- *Ex post* usage
  - providing arguments in favor of an already taken decision
  - providing an umbrella
  - delaying the process
  - etc.

Decision Analysis

- **Definition (B. Roy): "consists in trying to provide *answers* to questions raised by actors involved in a *decision process* using a *model*"**
- ***Answers*: "Optimal solution" or "Good decision" is absent**
- ***Models*: formalized or not**

Examples of models

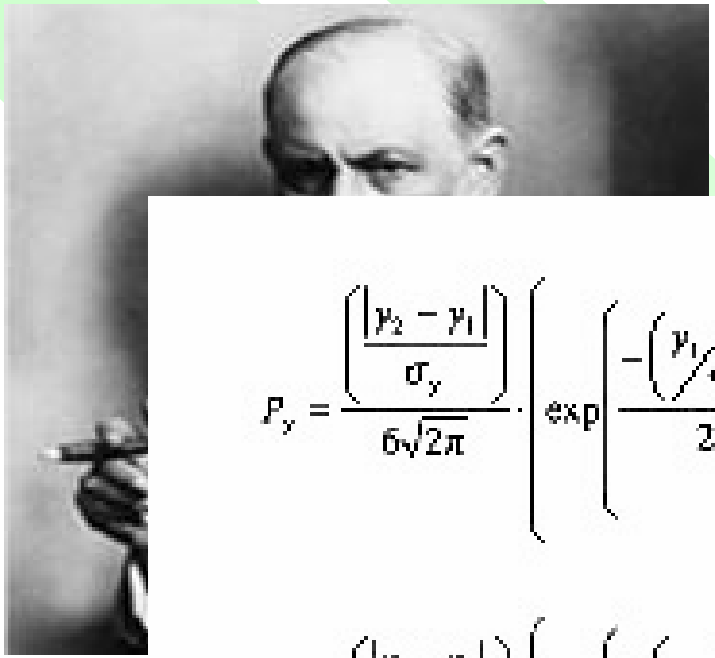
- **Astrology**
  - **the astrologer "provide *answers* to questions raised by his/her client using a *model*"**

The infotech revolution is fifty years young for despite all the innovation and surprises served up to date, it is quite clear that far greater change lies ahead. We marvel at how computers have insinuated themselves into every corner of our lives, knowing all the while that in a few years today's marvels will seem quaint compared to what follows. Amid all this change, a half-century of history provides us with one important constant - a clear trajectory of innovation and consequence that reveals important insights about the nature of surprises to come.

- **Graphology**
- **Psycho-analysis**
- **Decision analysis makes use of *explicit* and *formalized* models**

$$P_y = \frac{\left(\frac{|y_2 - y_1|}{\sigma_y}\right)}{6\sqrt{2\pi}} \cdot \left(\exp\left[\frac{-\left(\frac{y_1}{\sigma_y}\right)^2}{2} \right] + 4 \cdot \exp\left[\frac{-\left(\frac{y_1 + y_2}{2\sigma_y}\right)^2}{2} \right] + \exp\left[\frac{-\left(\frac{y_2}{\sigma_y}\right)^2}{2} \right] \right)$$

$$P_x = \frac{\left(\frac{|x_2 - x_1|}{\sigma_x}\right)}{6\sqrt{2\pi}} \cdot \left(\exp\left[\frac{-\left(\frac{x_1}{\sigma_x}\right)^2}{2} \right] + 4 \cdot \exp\left[\frac{-\left(\frac{(x_1 + x_2)}{2\sigma_x}\right)^2}{2} \right] + \exp\left[\frac{-\left(\frac{x_2}{\sigma_x}\right)^2}{2} \right] \right)$$



$$P_y = \frac{\left(\frac{|y_2 - y_1|}{\sigma_y}\right)}{6\sqrt{2\pi}} \cdot \left(\exp\left(\frac{-\left(y_1/\sigma_y\right)^2}{2} \right) + 4 \cdot \exp\left[\frac{-\left(\frac{y_1 + y_2}{2\sigma_y}\right)^2}{2} \right] + \exp\left(\frac{-\left(y_2/\sigma_y\right)^2}{2} \right) \right)$$

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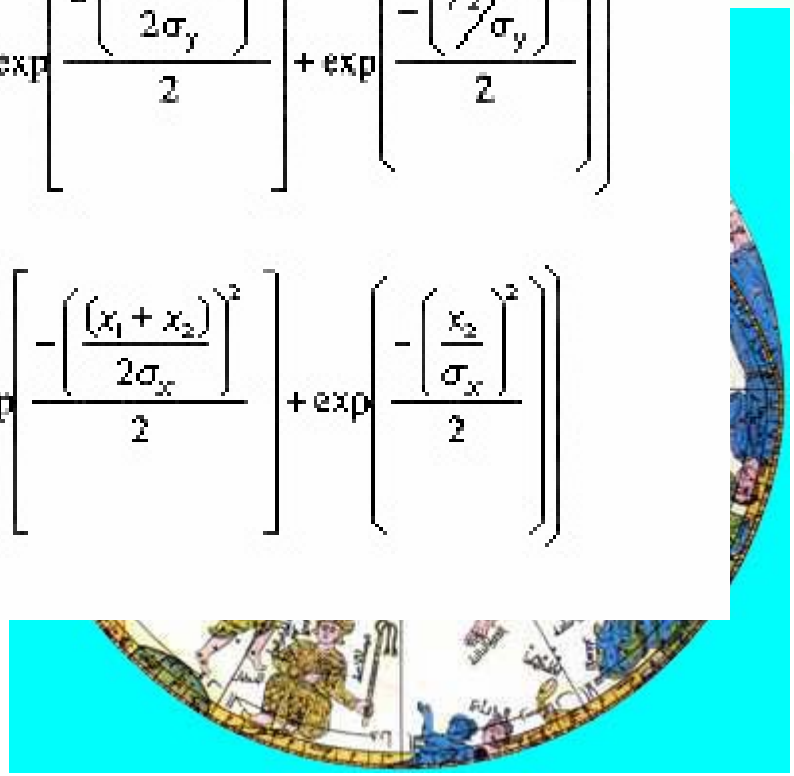


Formalized Models

- Drawbacks
  - Complex
  - Opaque
- Advantages
  - Provide a clear language
    - communication tool
  - Capture the essence of a situation
    - structuration tool
  - Answers "what-if" questions (sensitivity, robustness)
    - Exploration tool
- Example: choosing a bottle of wine

Possible Objections

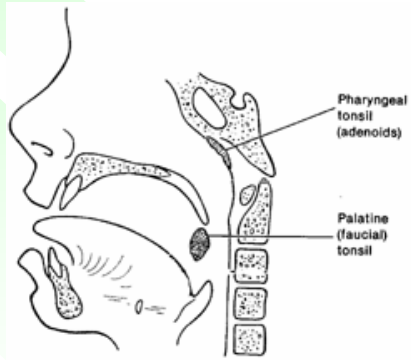
- ***I*** **do not need such tools because** ***I*** **know how to decide**
- **Let's organize a high-level** ***meeting*** **to discuss it**
- ***Intuition*** **is often enough**

I do not need it

- **OK but:**
  - **How will you convince your Boss?**
  - **How will you avoid being a scapegoat?**

Intuition?

- Doctors
- New England Journal of Medicine
  - Tonsillectomy
  - Experts + Clinical Tableaus



389 child

- **45 % Yes**
- **55 % No**
  - **46 % Yes**
  - **54 % No**
    - **44 % Yes**
    - **56 % No**

Example

You are confronted with the *double* decision problem:

***Problem 1*. Choose between**

- **Option A = sure gain of 1200 €**
- **Option B = gain of 5000 € with probability 25%, no gain with probability 75%**

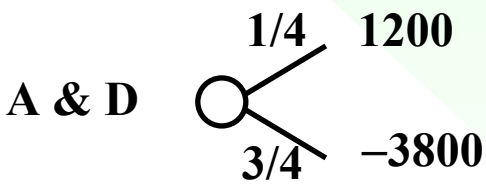
***Problem 2*. Choose between:**

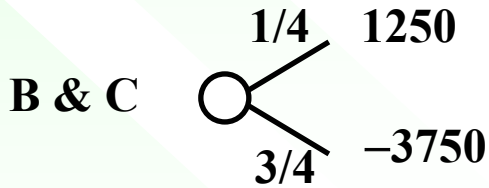
- **Option C = sure loss of 3750 €**
- **Option D = loss of 5000 € with proba. 75 %, no loss with proba. 25%**

- **Make your own choices!**

Results
Daniel Kahneman & Amos Tversky

- **Modal choice = A & D (73%)**





Daniel Kahneman

Trap # 6

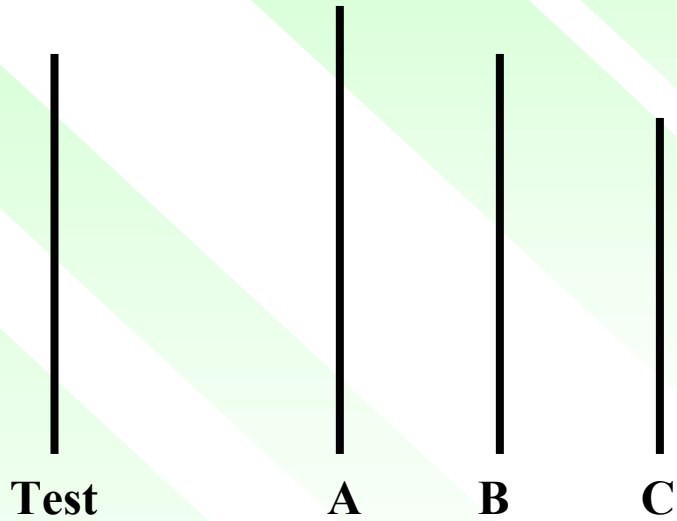
Shooting from the hip

- **"Believing that you can keep straight in your head all the information you've discovered, and therefore "winging it" rather than following a systematic procedure when making the final choice"**

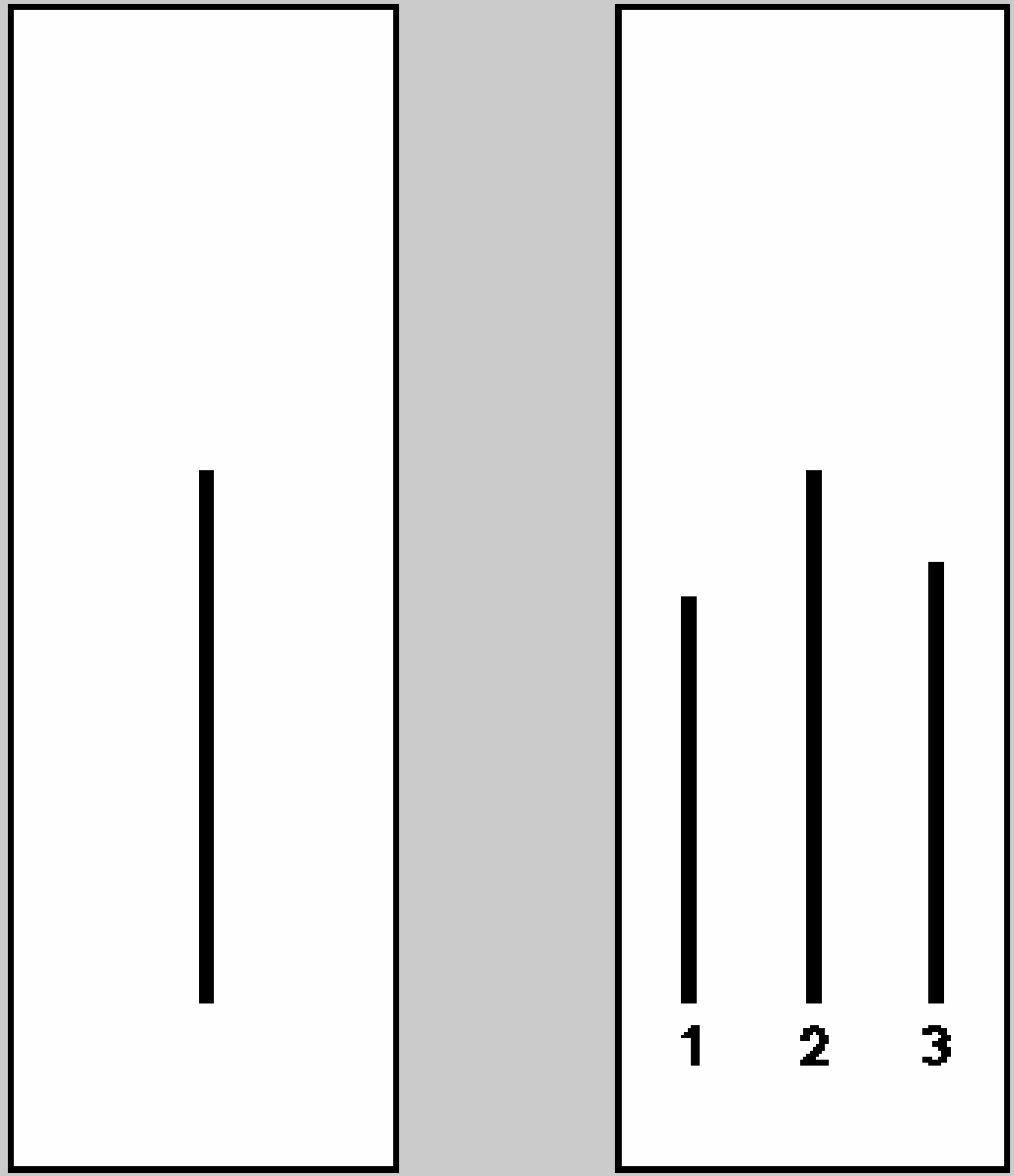
Russo & Shoemaker

Meetings

- Asch experiment



- 99% correct answers
  - 1 person says A — error rate = 3%
  - 2 person say A — error rate = 13 %
  - 3 person say A — error rate = 33 %
  - Bonus for correct consensus — error rate = 47 %


1
2
3

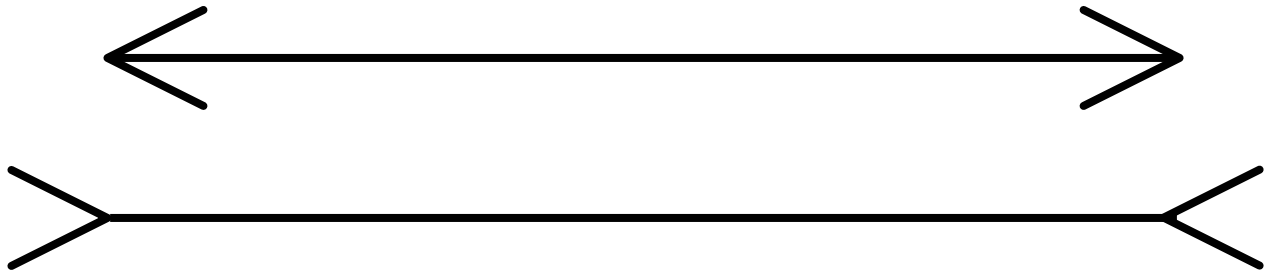
Trap # 7

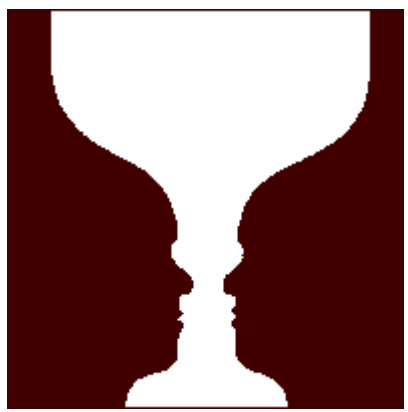
Group failure

- **"Assuming that with many smart people involved, good choices will follow automatically, and therefore failing to manage the group decision-making process"**

Russo & Shoemaker

Optical Illusions



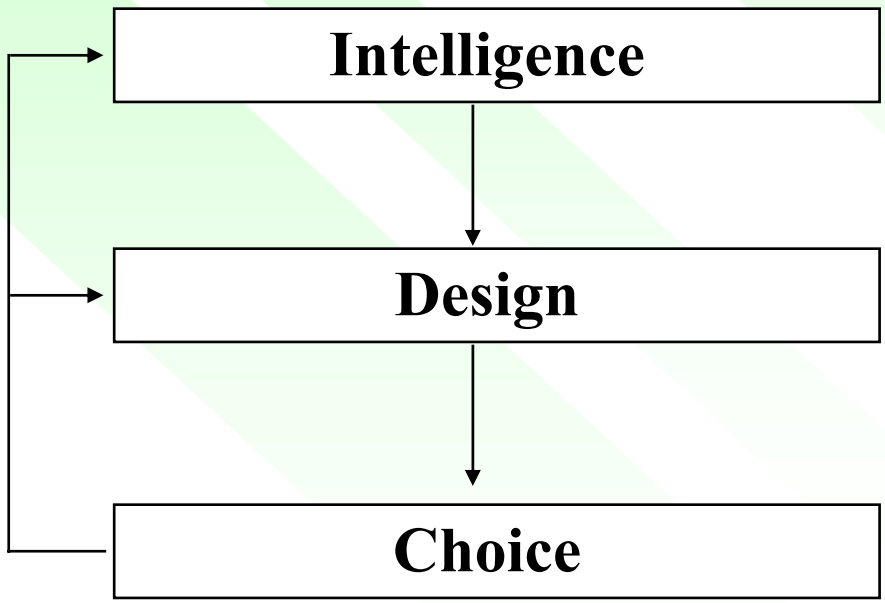


What can be expected?

- Separate “facts” and “values”
- Separate “robust” from “fragile” conclusions
- Improve communication
- Foster consistent reasoning
- Draw attention to counter-intuitive and perverse effects
- Promote open debate and discussion
- Promote partial agreements
- Promote reflection on objectives

Simple Decision Process Model

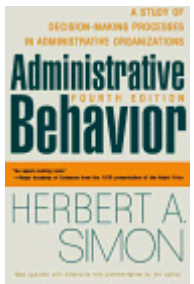
Herbert Simon



Herbert Simon

- **Nobel Prize in Economics (1978)**

  "for his pioneering research into the decision-making process within economic organizations"



Trap # 1

Plunging In

- **“Beginning to gather information and reach conclusions without taking first a few minutes to think about the crux of the issue you’re facing or to think how you believe decisions like this one should be made”**

Russo & Shoemaker

Trap # 10

Failure to audit your decision process

- **“Failing to create an organized approach to understanding your own decision-making, so you remain constantly exposed to all other nine decision traps”**

Russo & Shoemaker

Intelligence

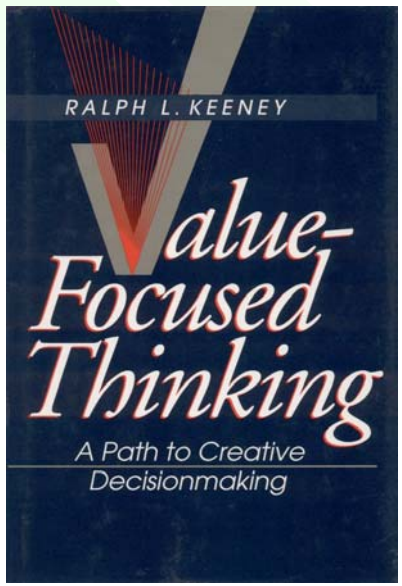
- Triggering the “decision situation”
  - having the right triggers
- Values & Objectives
- Frontier of the system
- Possible actions on the system
  - Norman R. F. Maier: “do not propose solutions until the problem has been thoroughly discussed without suggesting any”

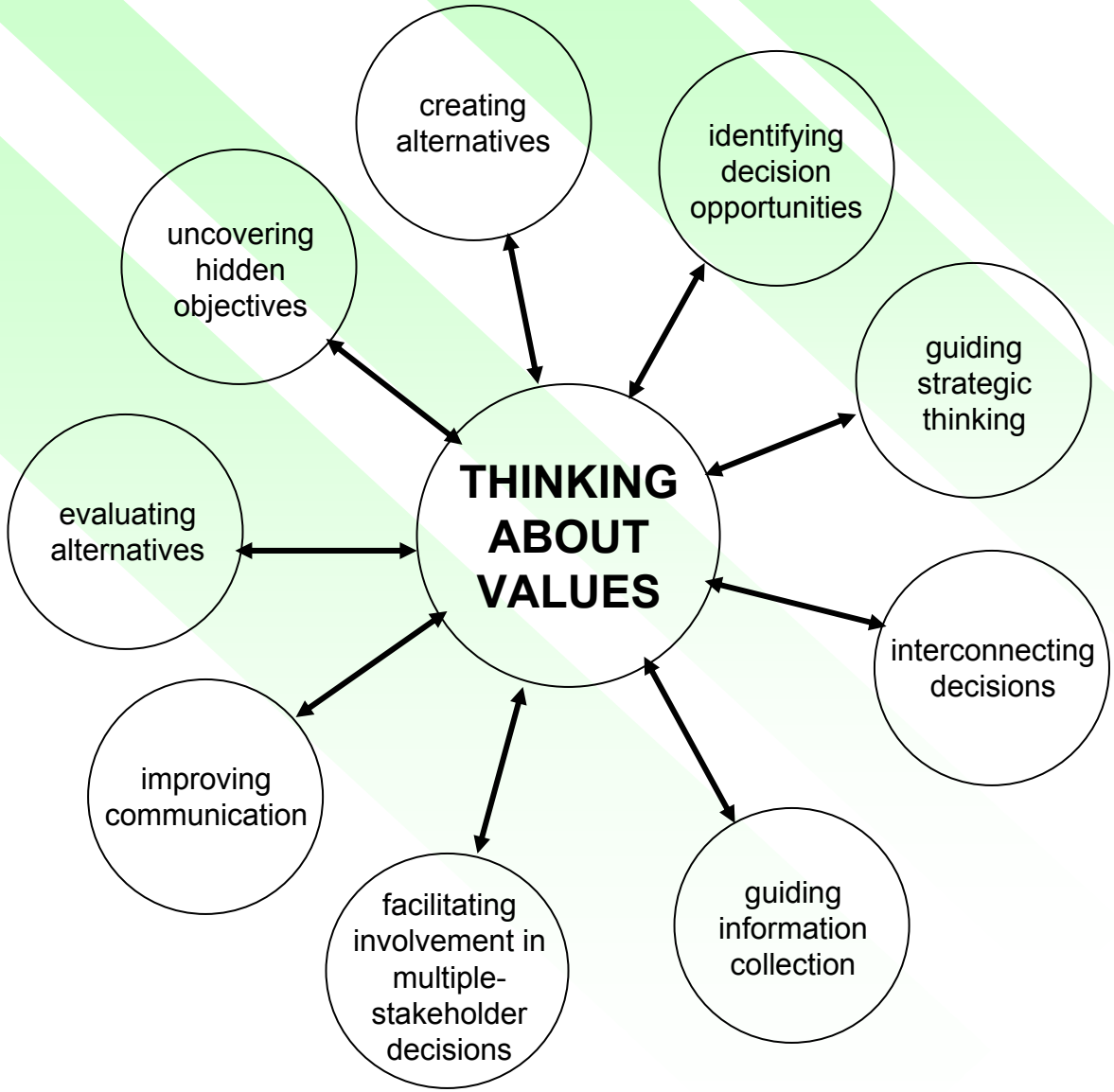
Triggers: Information Systems

- **MIS / EIS / Accounting / Inventory management**
- **Watch**
- **Prospective**
- **Information**
  - **of *adequate* nature**
  - **in a *timely* manner**

Values - Objectives

- **"Decision-Making is what you do to satisfy objectives" (R.L. Keeney)**
- **Objectives**
  - **guide the collection of information**
  - **facilitate communication**
  - **allow audits and evaluation**
  - **avoid endless debates**
- **Examples**
  - **Should we legalize Cannabis ?**
  - **What should be the speed limit on highways ?**
  - **Should I take this job?**





Adapted from Keeney, 1992

Values - Objectives

- Ends objectives
  - Why is this important to me ?
  - Evaluation
- Means objectives
  - How ?
  - Alternatives
- Means Objective: an objective whose importance stems from its contributions to achieving another objective.
- Fundamental Objective: objective that defines a basic reason for caring about a decision.
  - Means Objective - arrive home from work early
  - Fundamental Objective - make my spouse happy

The Art of Identifying Objectives

- **Step 1: Write down all the concerns you hope to address through your decision**
- **Step 2: Convert your concerns into succinct objectives**
- **Step 3: Separate ends from means to establish your fundamental objectives**
- **Step 4: Clarify what you mean by each objective**
- **Step 5: Test your objectives to see if they capture your interests**

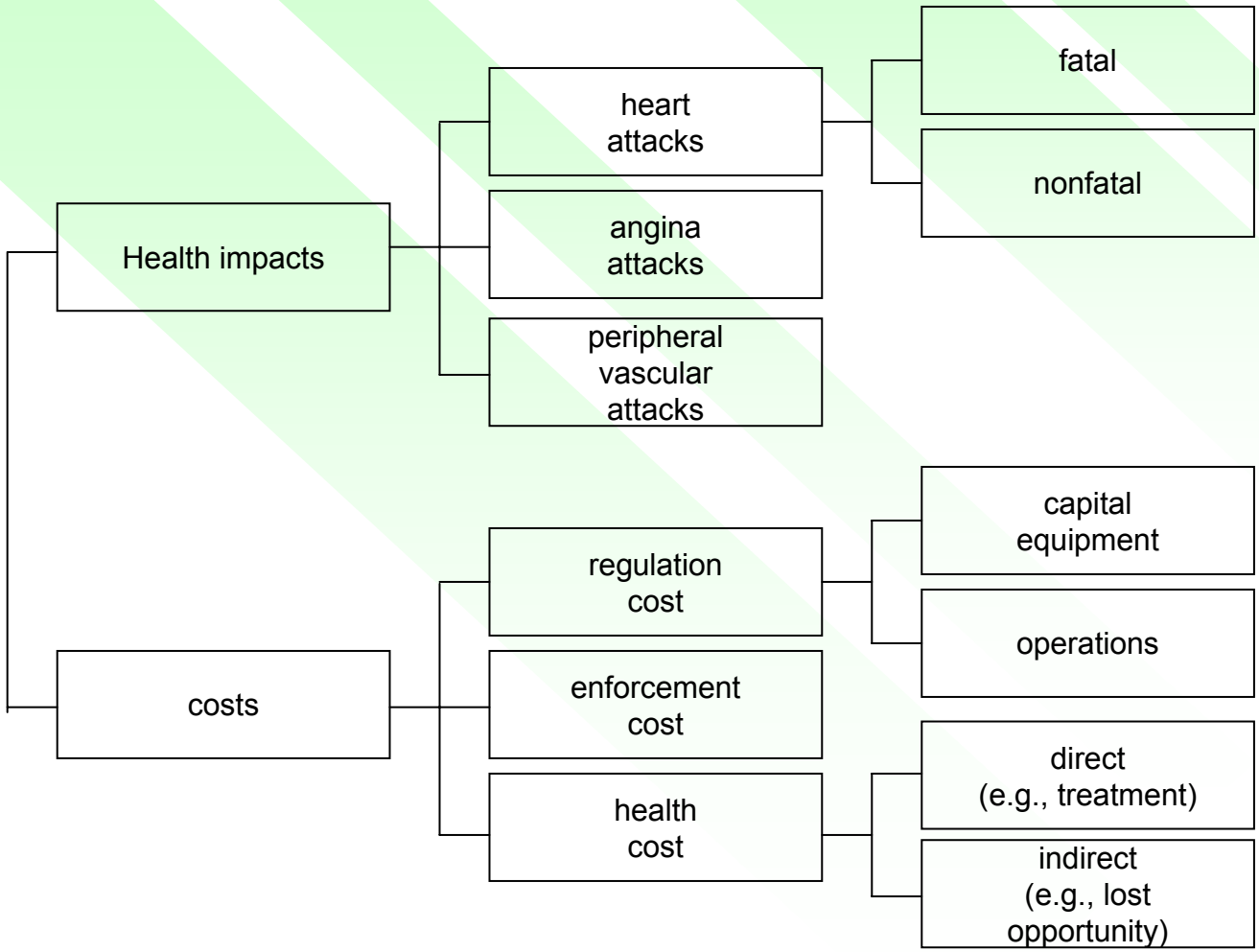
Techniques to Identify Objectives

- Use a wish list
- Think about alternatives
- Imagine possible consequences
- Describe problems and shortcomings
- Identify goals, constraints and guidelines
- Use different perspectives
- Think about strategic objectives
- Ask ‘why’ for each objective
- Do individual thinking first

Fundamental Objectives Hierarchy

- **Fundamental objectives can be structured in a hierarchy**
  - **The most general objective is at the top**
  - **Lower-level objectives explain the meaning of upper-level objectives**
  - **Achievement of the lowest-level objectives can be measured using "attributes" to describe and evaluate the various alternatives**

Fundamental Objectives Hierarchy
CO Air Quality Standards

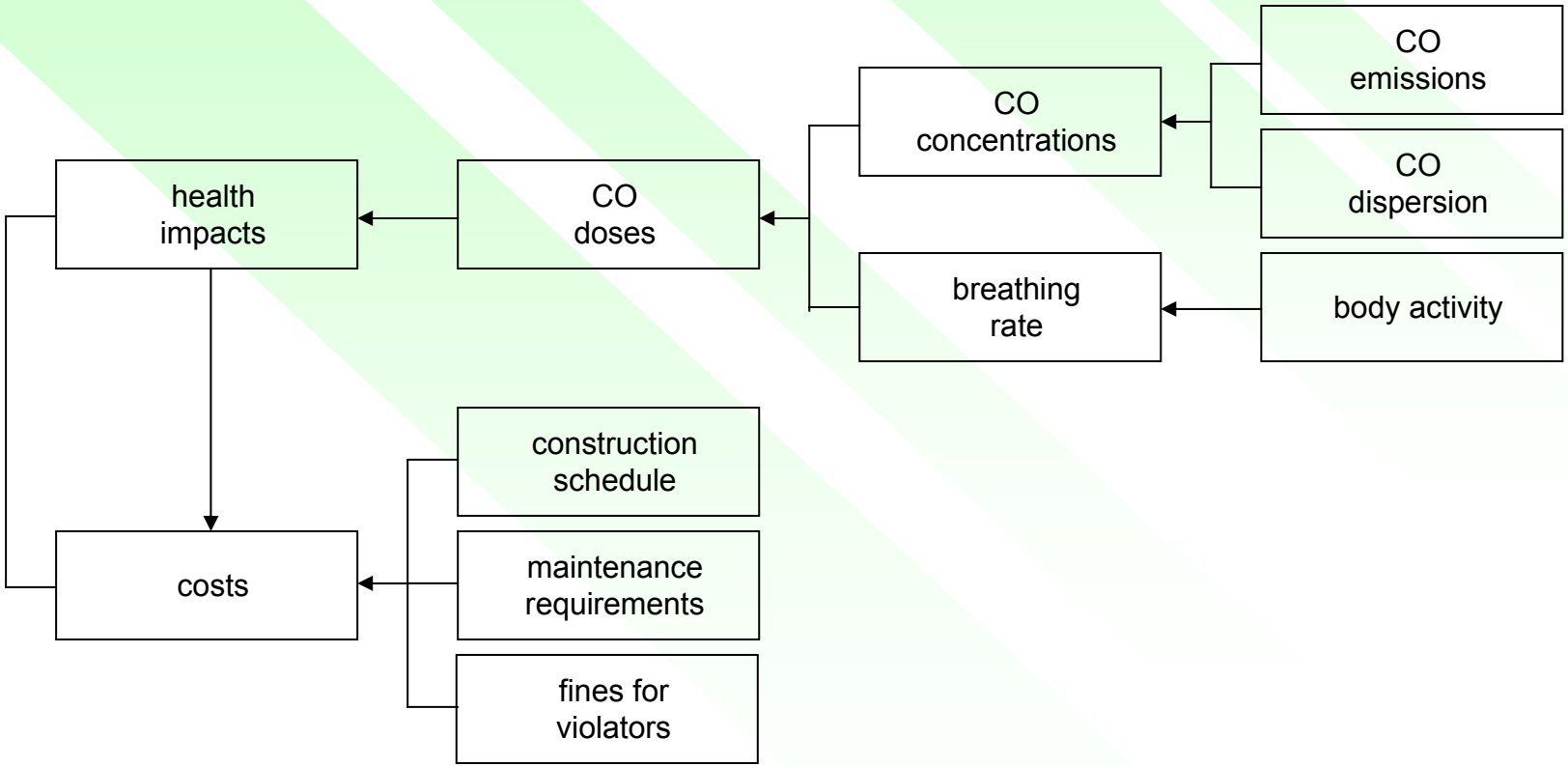


Adapted from Keeney, 1992

Means-Ends Objectives Network

- **Means objectives and fundamental (ends) objectives can be related in a means-ends network**
  - **The network of means objectives shows how the corresponding fundamental objectives can be achieved**
  - **A Means-Ends objectives network can be used to generate alternatives**

Means-Ends Objectives Network
CO Air Quality Standards



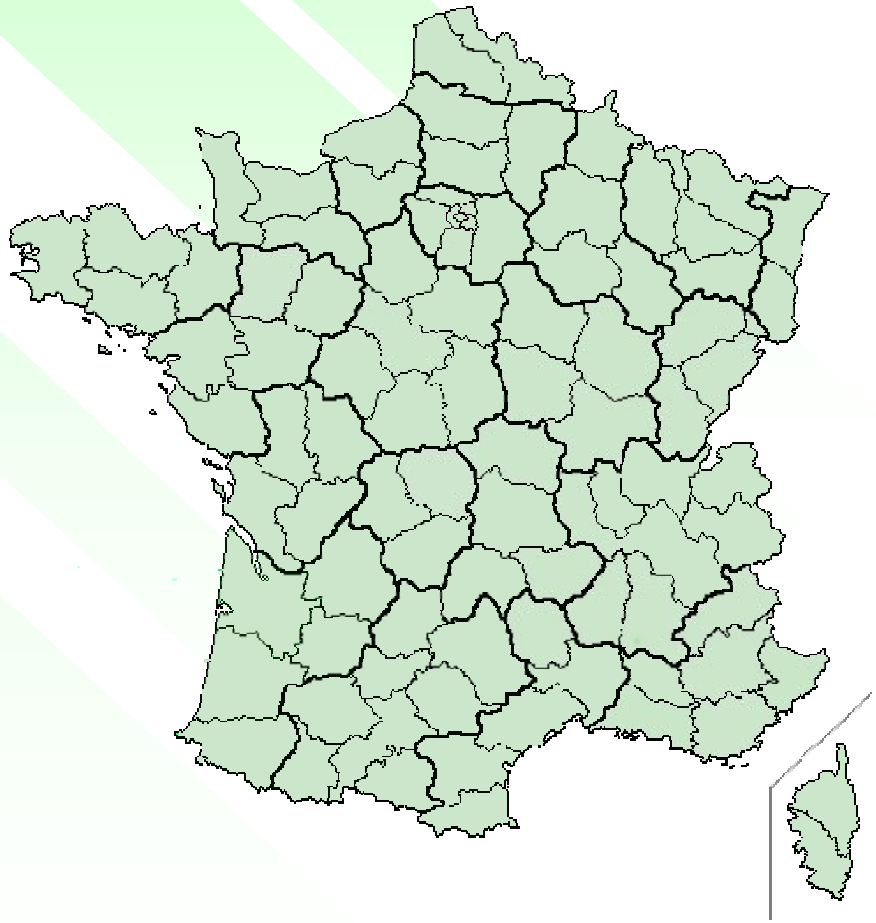
Adapted from Keeney, 1992

Summary of How to Construct Objectives Hierarchies and Networks

	Fundamental Objectives	Means Objectives
To Move:	Downward in the Hierarchy:	Away from Fundamental Objectives:
Ask:	"What do you mean by that?"	"How could you achieve this?"
To Move:	Upward in the Hierarchy:	Toward Fundamental Objectives:
Ask:	"Of what more general objective is this an aspect?"	"Why is this important?"

Frontiers

- A model *has to* simplify
- Frontiers
  - Time
  - Space
  - Persons
  - Linked decisions
- Examples
  - Elevators
  - J-I-T

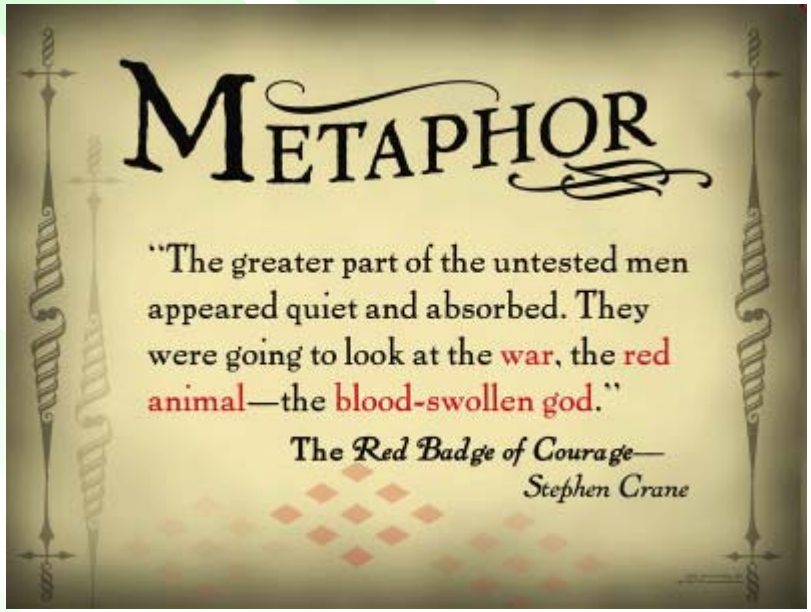


Frontiers

- Key points?
- Neglected points?
- Traps
  - Metaphors, language
  - Firm stereotypes
  - Trigger
  - Obvious constraints

Metaphors

- **Sports / War / Health, etc.**
  - **Price war**
  - **Terminal phase**
  - **Strategic movement**
  - **General mobilization**
  - **Battle of quality**
  - **etc.**



Trap # 2

Frame Blindness

- **“Setting out to solve the wrong problem because you have created a mental framework for your decision with little thought that causes you to overlook the best options or lose sight of important objectives”**

Russo & Shoemaker

Trap # 3

Lack of Frame Control

- **"Failing to consciously define the problem in more than one way or being unduly influenced by the frames of others"**

Russo & Shoemaker

Example
Kahneman & Tversky

- **You have decided to go to see a play and bought a ticket for 30 €**

  As you enter the theater, you discover that you have lost the ticket. The seat was not marked and the ticket cannot be recovered.

  Would you pay 30 € for another ticket to see the play (assuming you have enough cash)

- **38 % do not buy**

Example
Kahneman & Tversky

- You have decided to go to see a play where admission is 30 € per ticket, but you have not yet purchased the ticket. As you enter the theater, you discover that you have lost 30 € from your wallet.

  Would you still pay 30 € for a ticket to see the play (assuming you have enough cash).

- 17 % do not buy (vs. 38%)

- Lost cash is “out-of-boundary”

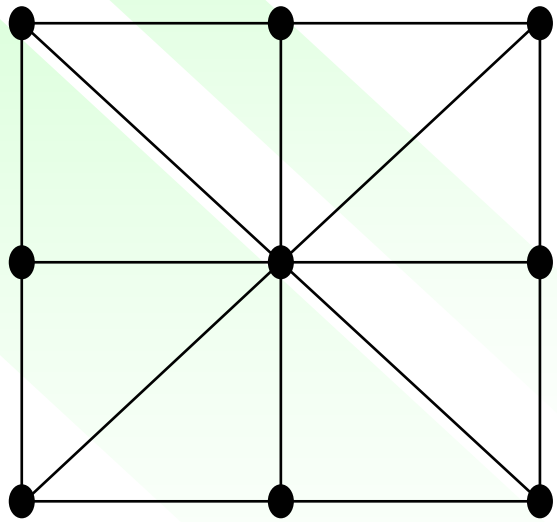
Set of alternatives

- Let *A* be a an exhaustive set of mutually exclusive alternatives
- Creativity
  - test: is there at least one satisfactory alternatives?
- R.L. Keeney
  - “your decision cannot be better than your best alternative”
  - “you can never choose an alternative you haven’t considered”


CREATIVITY
IT JUST WON'T GET OFF THE GROUND
FEAR
CONDITIONING

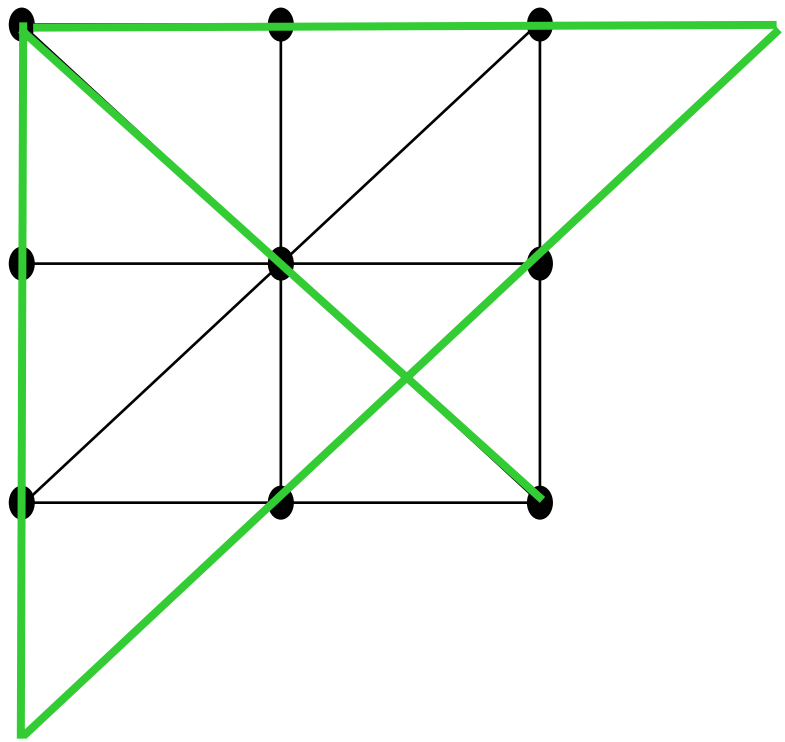
Classical Problem

- **Join these 9 points by 4 lines without lifting the pencil from the paper**



- **Problem posed to thousands of persons**

Self-imposed constraints



Problem: Complete last line

1

11

21

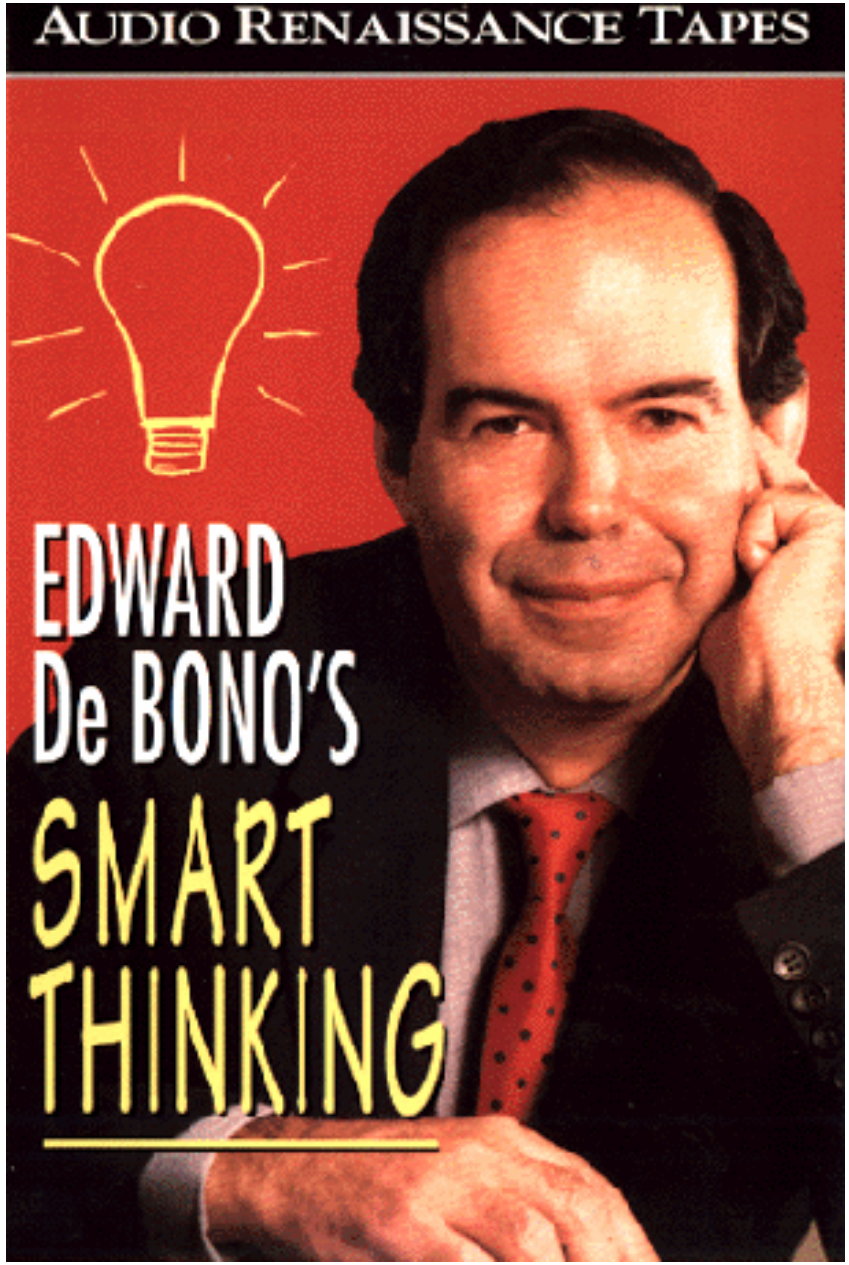
1211

111221

312211

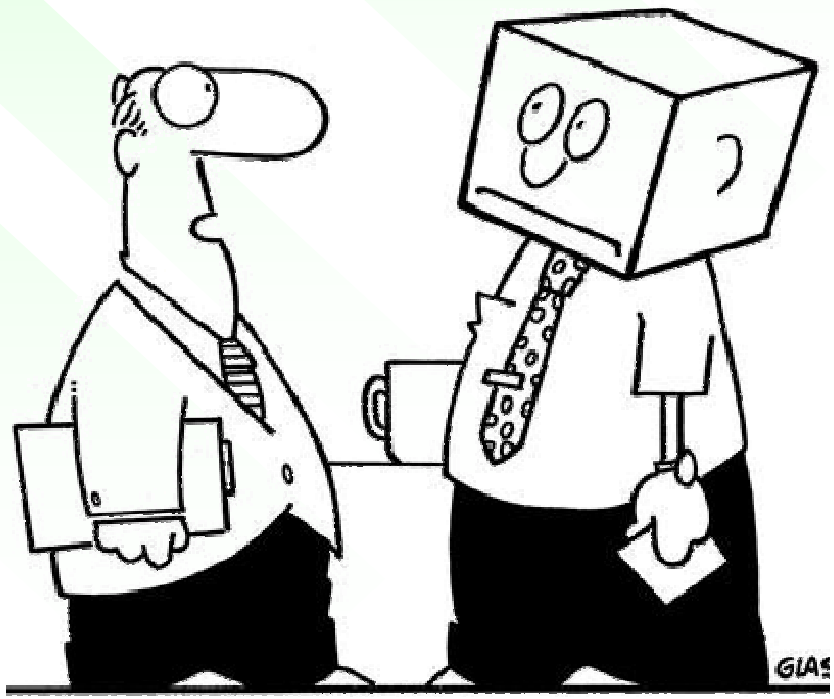
13112221 ??

1113213211


AUDIO RENAISSANCE TAPES
EDWARD
De BONO'S
SMART
THINKING

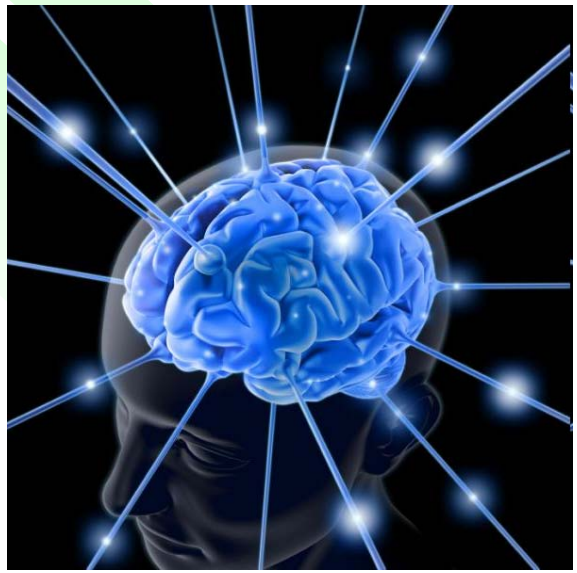
Creativity Killers

- Business as usual: budgets
- Status-quo bias
- No action: letting time/others decide for me
- Fear of being ridiculous
  - Brainstorming sessions
  - US army



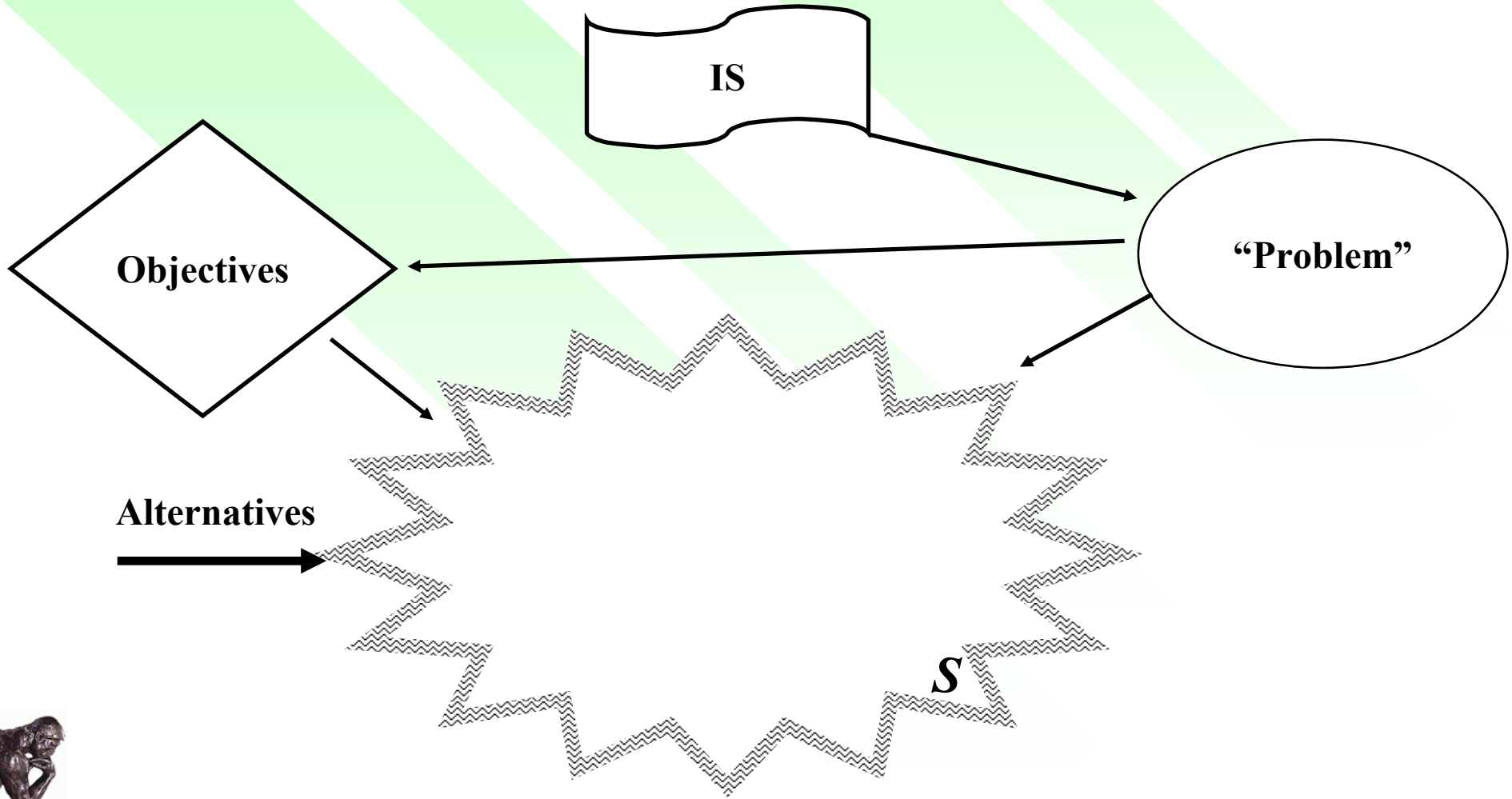
Remedies

- Use your objectives and ask: How?
- Increase aspiration levels
- Beware of constraints
- Sleep on it
- Modify / improve what is “given”



- Test: Is there anything really satisfactory?

Intelligence Phase



Design

- Describe / forecast the “state of the system” if you apply some alternative
- Examples: most management techniques
  - sales forecasts, financial plans, accounting
- Job
  - salary
  - transportation time
  - social security
  - nights out
  - interest
  - chances of keeping the job

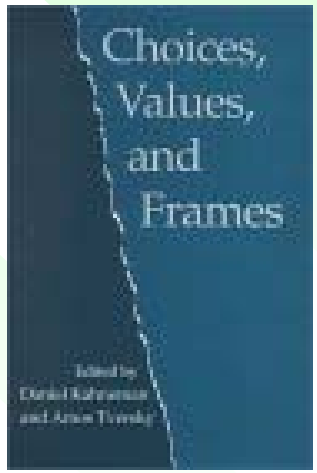
Traps

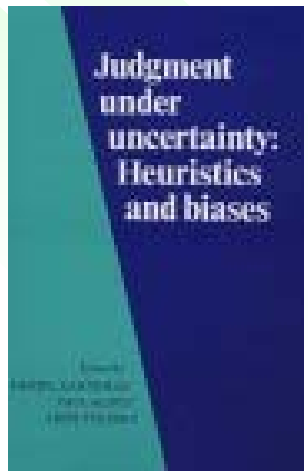
- **Not using your objectives**
- **Not having objectives**
- **Fetishing “hard data”**
- **Not taking uncertainty into account**
- **Mixing up *knowledge* of experts with their *values***
  - **doctors**

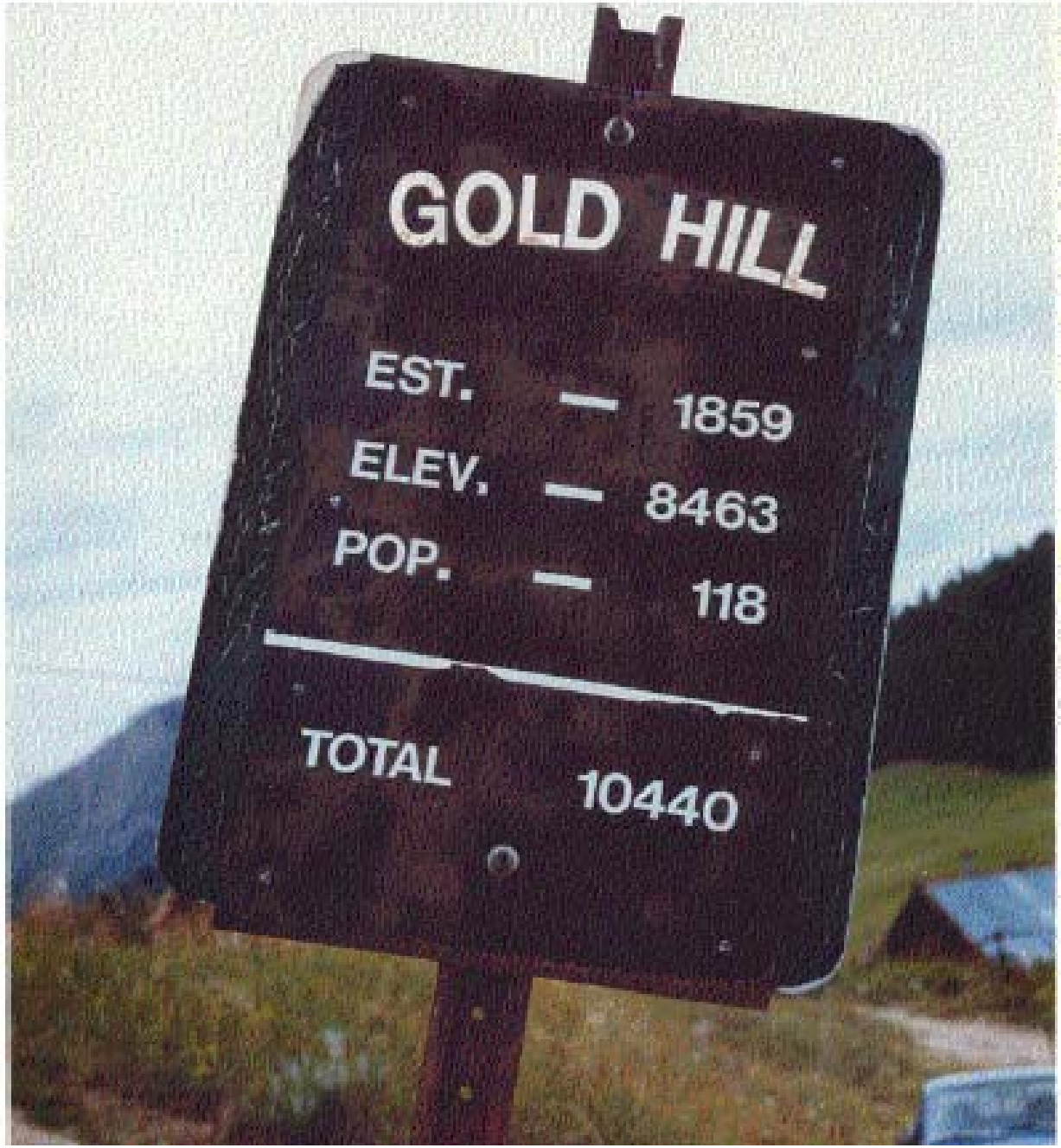
Design: crucial points

- What do I know?
- What should I know?

- Reference points
- Units
  - nature of the measure
  - absolute/relative

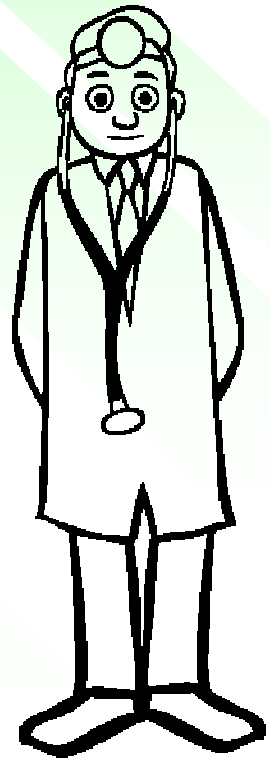





GOLD HILL
EST. — 1859
ELEV. — 8463
POP. — 118
TOTAL 10440

Example (Kahneman/Tversky)

- Experiment with 167 doctors
- Choice of a treatment for lung cancer
  - Surgery
  - Radiotherapy
- Information on survival “chances”
  - 2 groups



100 patients Surgery	10 die during operation
	32 are dead after 1 year
	66 are dead after 5 years
100 patients Radiother.	0 die during operation
	23 are dead after 1 year
	78 are dead after 5 years

50 % in Group 1 prefer Surgery

100 patients Surgery	90 survive to operation
	68 survive after 1 year
	34 survive after 5 years
100 patients Radiother.	100 survive to operation
	77 survive after 1 year
	22 survive after 5 years

84 % in Group 2 prefer Surgery

100 patients Surgery	10 die during operation
	32 are dead after 1 year
	66 are dead after 5 years
100 patients Radiother.	0 die during operation
	23 are dead after 1 year
	78 are dead after 5 years

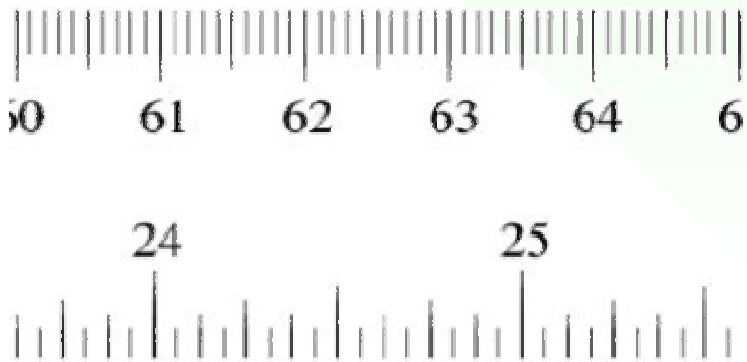
50 % in Group 1 prefer Surgery

100 patients Surgery	90 survive to operation
	68 survive after 1 year
	34 survive after 5 years
100 patients Radiother.	100 survive to operation
	77 survive after 1 year
	22 survive after 5 years

84 % in Group 2 prefer Surgery

Measurement units

- **Public Health decisions: mortality**
  - **Number of fatalities**
  - **Number of years of life lost**
  - **Number of years of "good quality" life lost**
    - **QUALY, HYE**



Absolute/Relative measurement

- **Situation A**

  Watch = 70 €

  You are told by a friend that, five blocks away, you can buy the same watch (same service and guarantee) at 30 €

  Question: Are you going to buy the watch in the distant shop? (90% Yes)

- **Situation B**

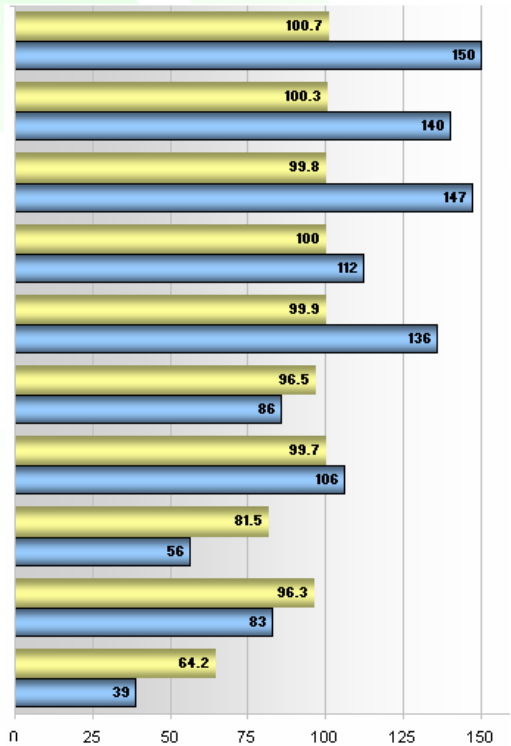
  Digital video camera = 800 €

  Five blocks away, you can buy the same video (same service and guarantee) at 760 €

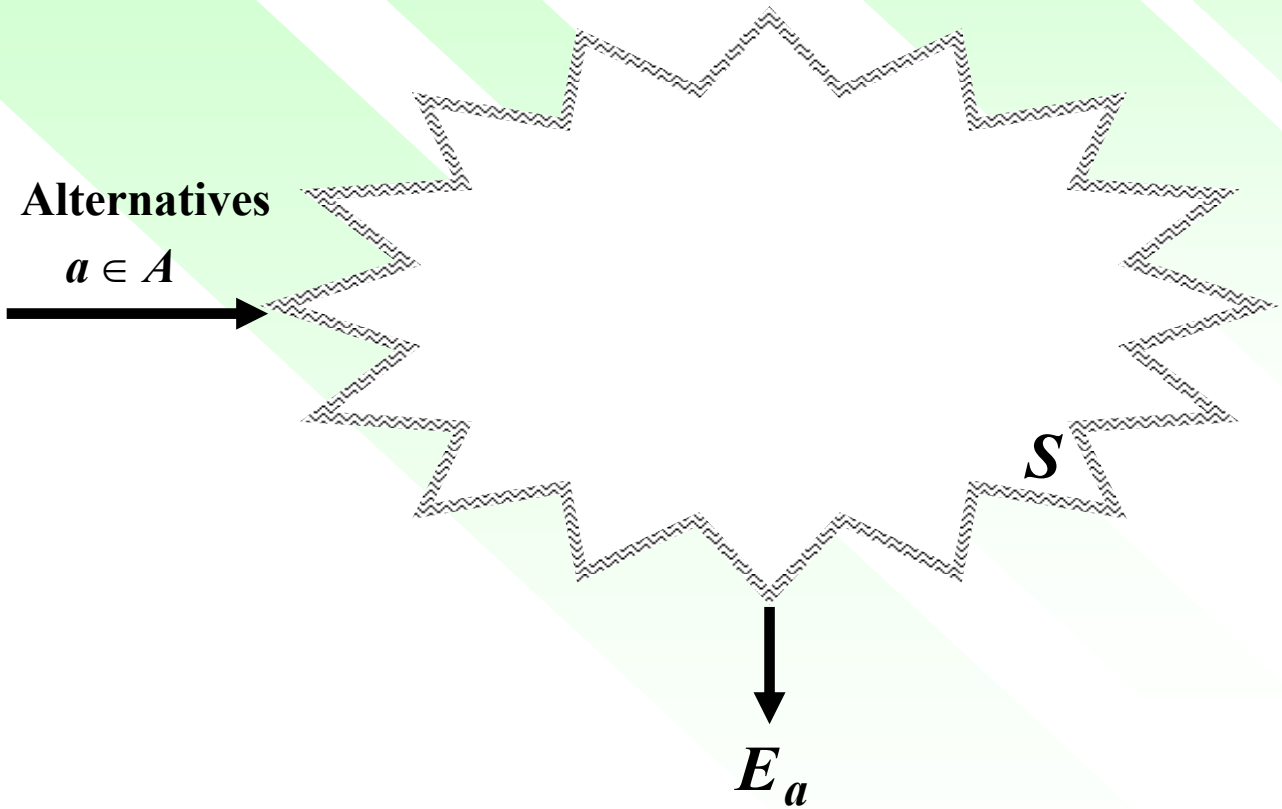
- **Question: Are you going to buy the video in the distant shop? (50% Yes)**

Absolute/Relative measurement

- **Budget: 100 000 €**
- **Expenditures : 90 000 €**
  - **“I saved 10 000 € to the firm”**
- **Expenditures : 110 000 €**
  - **“I stayed with 10% of the budget”**



Design Phase



Description of the system if you apply $a \in A$

Choice Phase

- **Choose alternative giving to system the "most desirable" state**

$$a \in A \rightarrow E_a$$
$$b \in A \rightarrow E_b$$
$$c \in A \rightarrow E_c$$

- **Complexity depends on:**
  - A **(set of alternatives)**
  - S **(system)**
  - E_x **(description of system) / Objectives**
    - **Precision / Imprecision**
    - **Certainty / Risk / Uncertainty / Amibiguity**
    - **Time horizon**
    - **1 opinion / multiple opinions**
    - **1 criterion / several criteria**

Example:
Choice between investments projects

- **Intelligence: what are the possible investments?**
- **Design: Cash flows**
- **Choice: NPV or IRR**

$$v(a) = (v_0(a), v_1(a), \ldots, v_T(a))$$

$$VNP(a) = \sum_{t=0}^{T} \frac{v_t(a)}{(1+r)^t}$$

Meta Decision

- **How much time to allocate to each phase?**
- **Design: 80% of time (crunching numbers not to think hard)**

	real	wished
Intelligence	5%	20%
Design	45%	35%

Russo & Shoemaker

Trap # 9

- **Not keeping track**
- **“Assuming that experience will make its lessons automatically, and therefore failing to keep systematic records to track the results of your decisions and failing to analyze these results in ways that reveal their key lessons”**

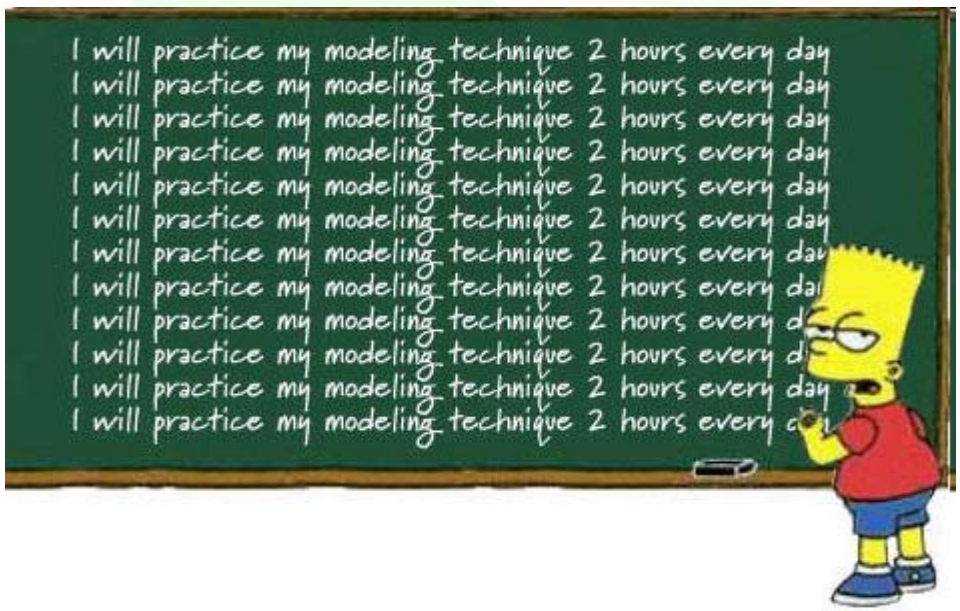
Russo & Shoemaker

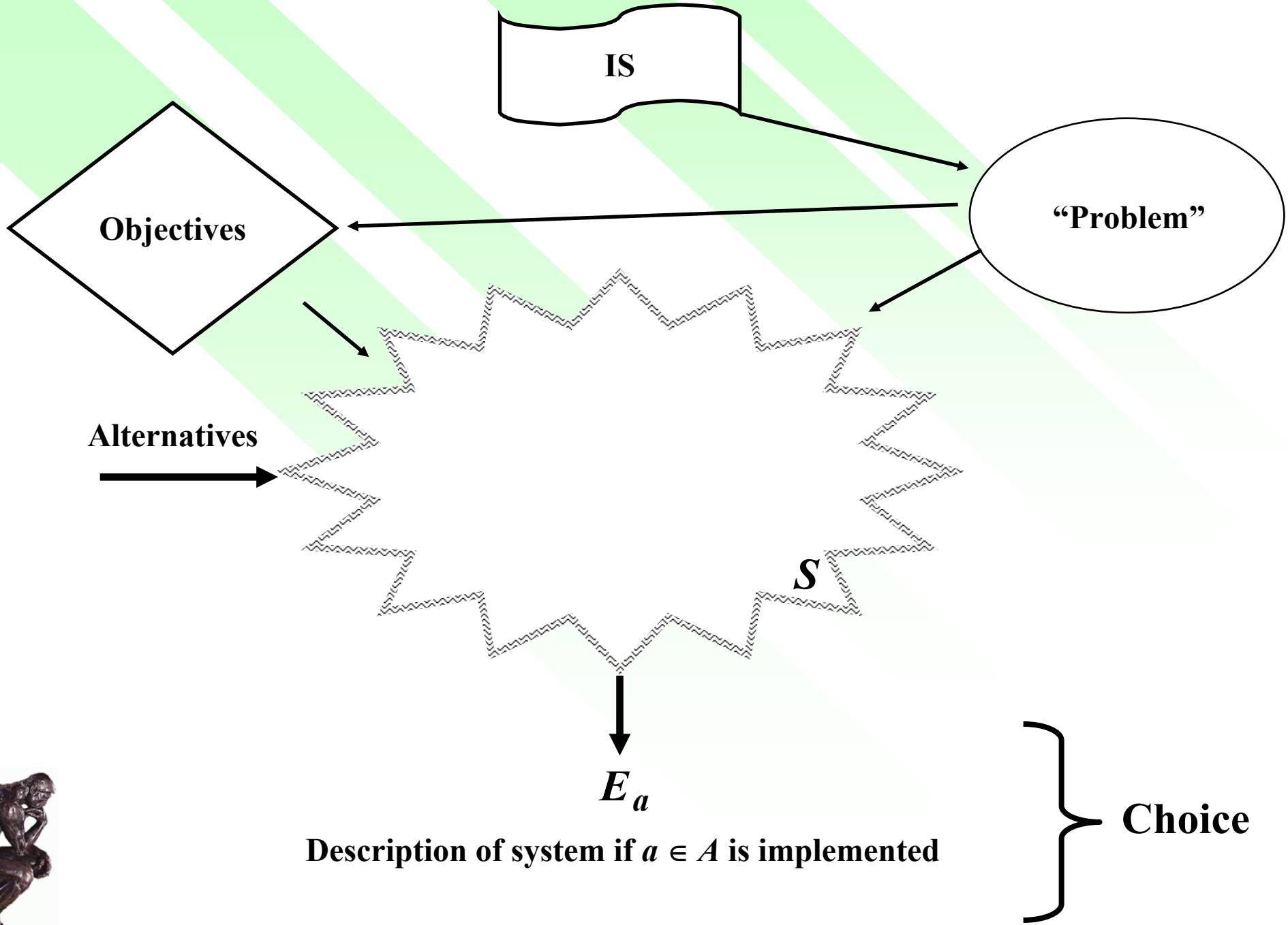
Difficulties: Choice

- Very high number of alternatives
- Interdependent decision
  - Resources
  - Time
- Uncertainty
- Time Horizon
- Multiple Criteria
- System with retro-action
- Group Decision

In Practice

- All difficulties are more or less present
- Design phase will put more emphasis on one or two depending on context
- Sometimes “Intelligence + Design” are enough to give sufficient insights into the situation




IS
Objectives
"Problem"
Alternatives
S
E_a
Description of system if $a \in A$ is implemented
Choice

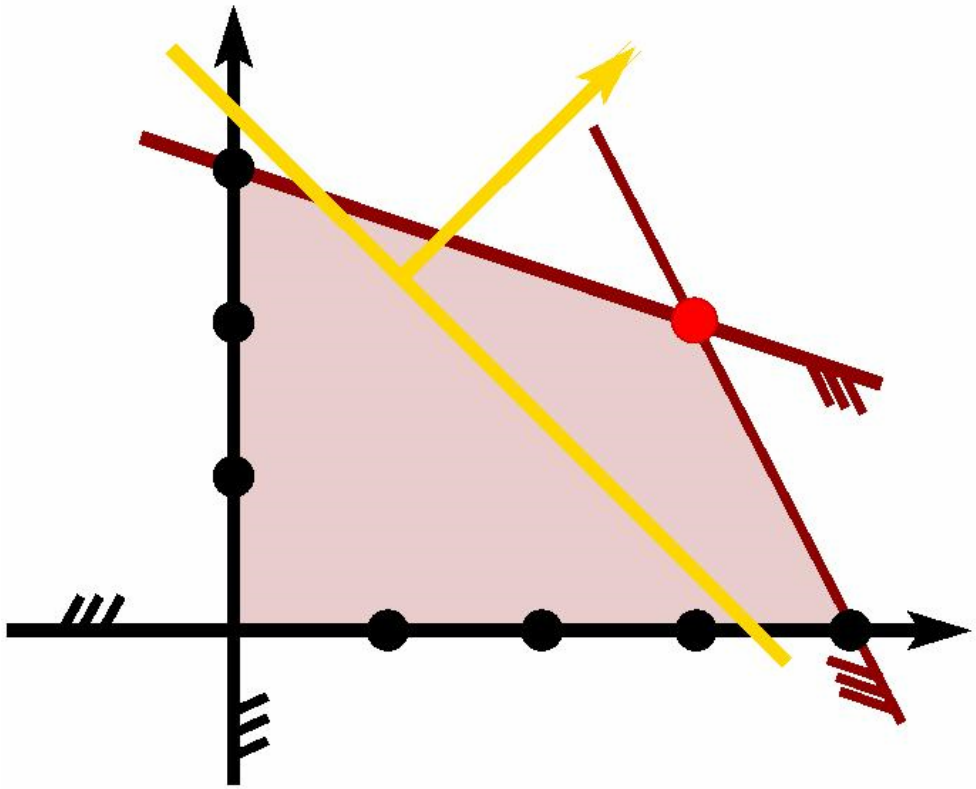
Classical techniques for Generic problems: Decision Theory

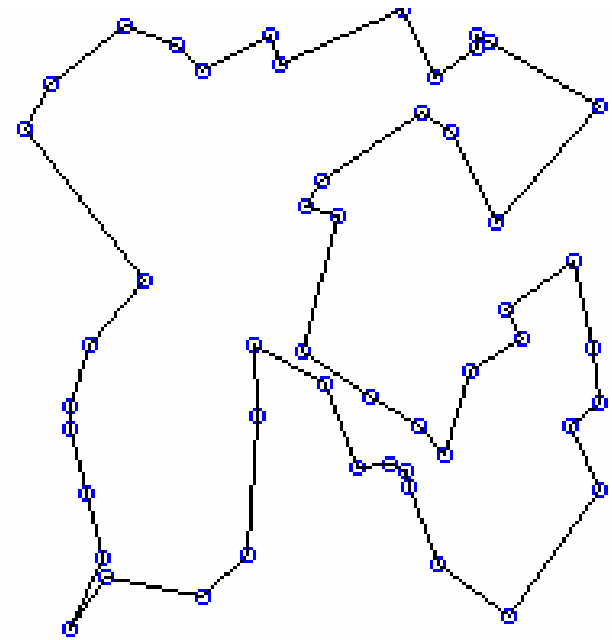
- **Very high number of alternatives**
- **Interdependent decision**

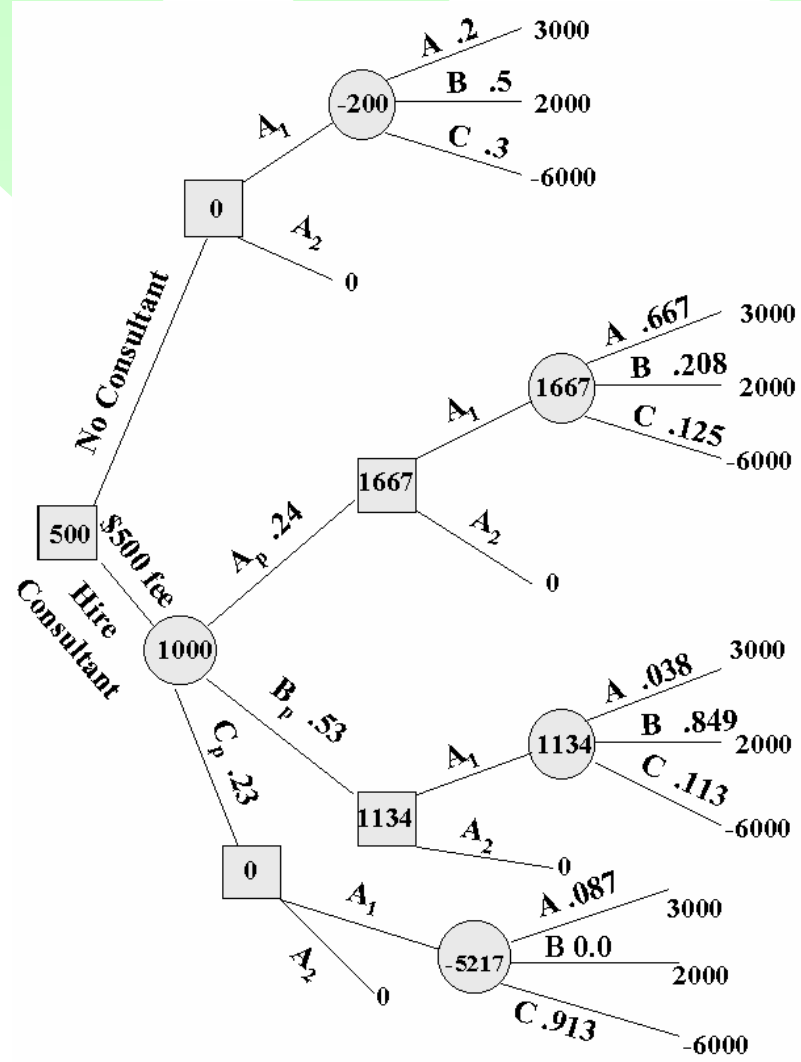
  Mathematical Programming

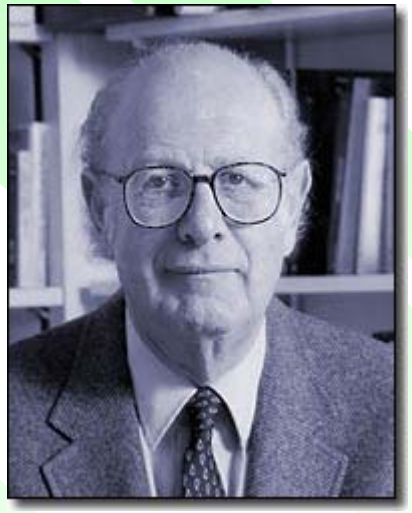
  Combinatorial Optimization
- **Uncertainty**

  Bayesian Decision Theory

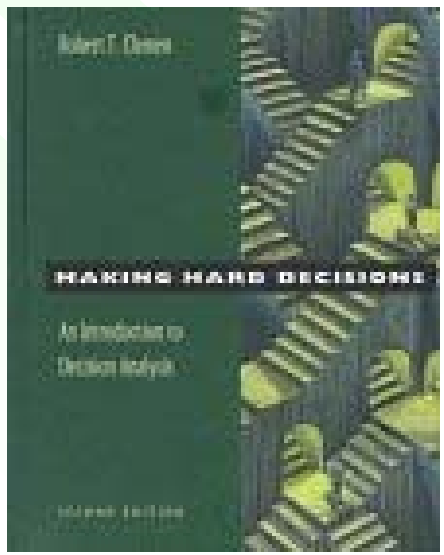


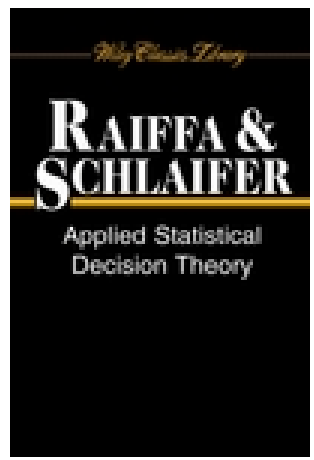



A .2
3000
B .5
2000
C .3
-6000
-200
A1
0
A2
0
No Consultant
A .667
3000
B .208
2000
C .125
-6000
1667
A1
1667
A2
0
500
$500 fee
Hire Consultant
Ap .24
1000
Bp .53
Cp .23
A .038
3000
B .849
2000
C .113
-6000
1134
A1
1134
A2
0
0
A1
A .087
3000
B 0.0
2000
-5217
A2
0
C .913
-6000

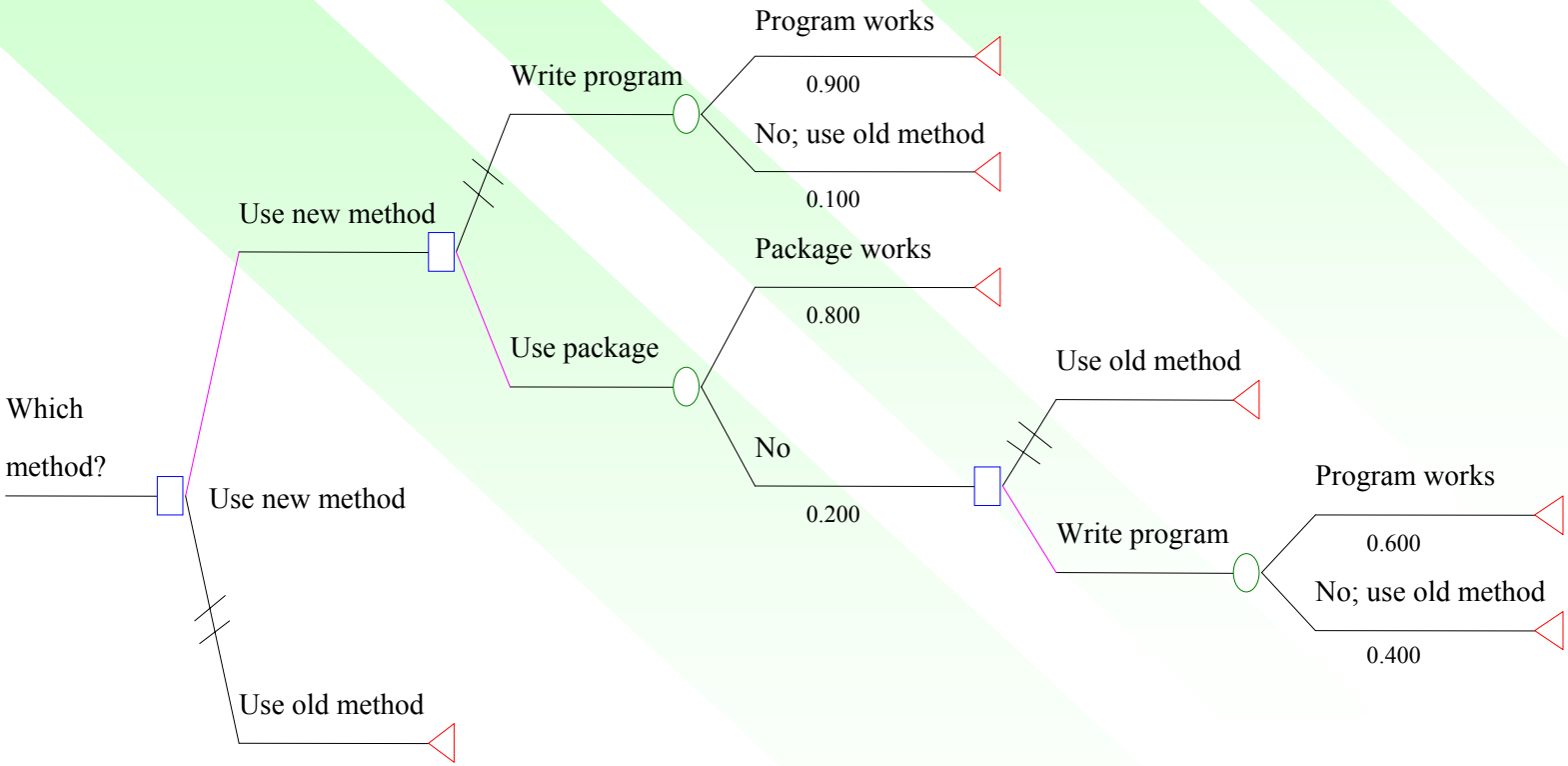



Leonard J. Savage
THE FOUNDATIONS OF
STATISTICS


Robert T. Clemen
MAKING HARD DECISIONS
An Introduction to
Decision Analysis


RAIFFA &
SCHLAIFER
Applied Statistical
Decision Theory

	Jesus' claims false	Jesus' claims true
I accept	some disappointment	infinite reward
I reject	no big deal	consider carefully!!! don't let it happen


Which
method?
Use new method
Use old method
Use new method
Write program
Use package
Program works
0.900
No; use old method
0.100
Package works
0.800
No
0.200
Use old method
Write program
Program works
0.600
No; use old method
0.400

Classical techniques

- **Time**

  Dynamic Programming - Optimal Control - Sustainable Development

- **Group Decisions**

  Social Choice Theory - Negotiation

- **Multiple Criteria**

  MCDM

- **Retroactions**

  Game Theory

Particular case: Optimization

- A is stable; alternatives are exclusive
- System and objectives allow to summarize E_x by a unique *performance measure*
- Examples
  - Profit, Sales, Quality, Jobs, Pollution
- $a \in \mathrm{A} \rightarrow E_a \rightarrow f(a)$

E_a preferred to E_b $\Leftrightarrow$ $f(a) > f(b)$

E_a indifferent to E_b $\Leftrightarrow$ $f(a) = f(b)$

Optimization

- **Choose an alternative $a \in A$ making**
  {Maximum *or* Minimum}
  the performance measure $f(a)$

$$\max_{a \in A} f(a) \quad \text{or} \quad \min_{a \in A} f(a)$$

- **Optimize = Maximize or Minimize**
  depending on the nature of $f(a)$

Definition

"Solving" $\boxed{\underset{a \in A}{\text{Max}}\ f(a)}$

means

"find, if any, an alternative $a^* \in A$ such that:

$f(a^*) \geq f(a)$, $\forall\ a \in A$"

- **Variants**
  - **find *all* optimal alternatives**
  - **find "good" alternatives**
  - **find "robust" alternatives**

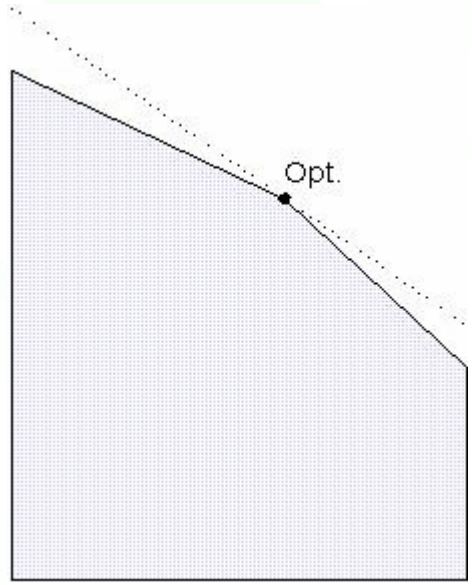
If any?

- **Possible cases**
  - $A = \varnothing$ **(no solution, no optimal solution)**
  - $A \neq \varnothing$

    f **bounded on** A

    ⇦ **Optimal solution or not**

    f **not bounded on** A **(no optimal solution)**



$$\max_{a \in A} f(a)$$

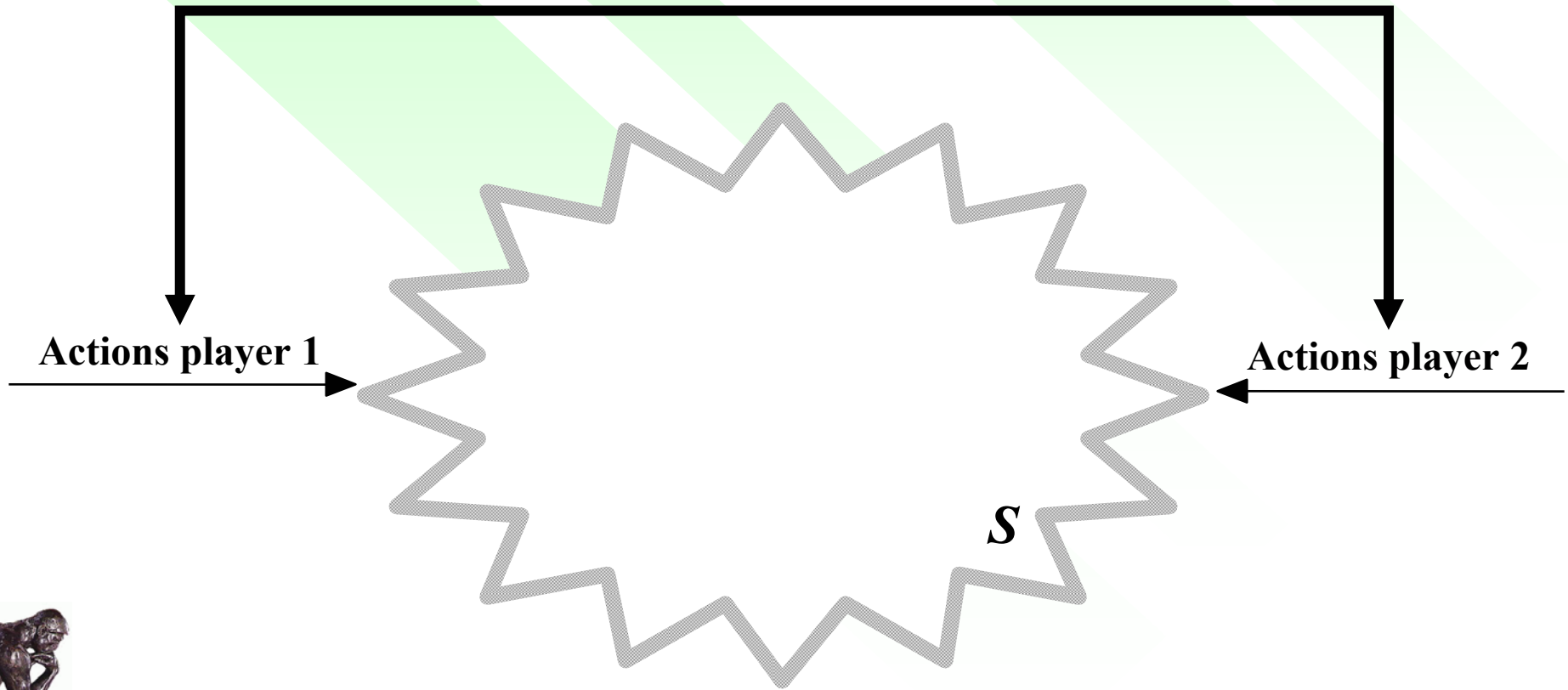
Optimal decision

- **Contingent upon:**
  - **Objectives**
  - ***S*: System**
  - ***A*: set of alternatives**
  - **E_a: Description of consequences**

$$\max_{a \in A} f(a)$$

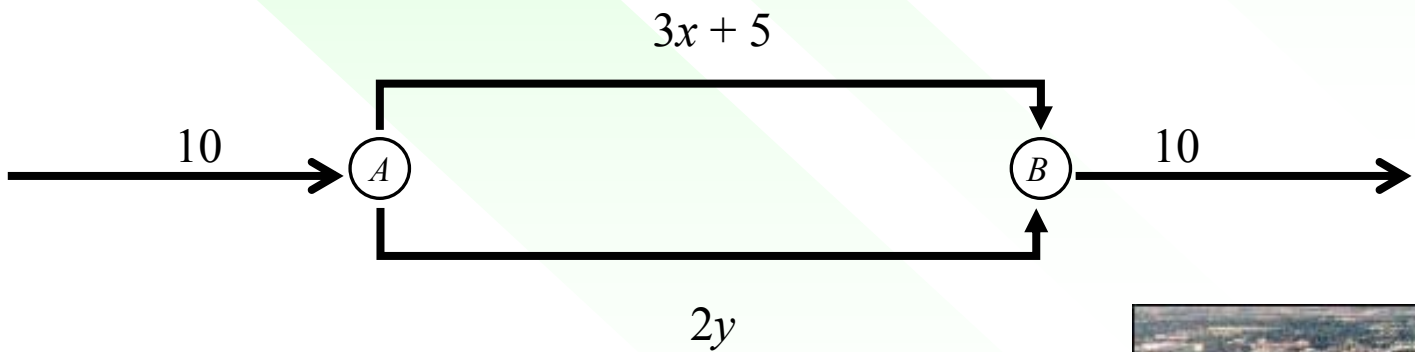
- **Optimization model is an *aid* to decision**
  - **discuss/modify the optimal solution**
  - **integrate neglected aspects**
  - **Redefine *S*, *A* or E_a**
- **In many cases the very idea of an "optimal solution" is meaningless**

Example: retroaction



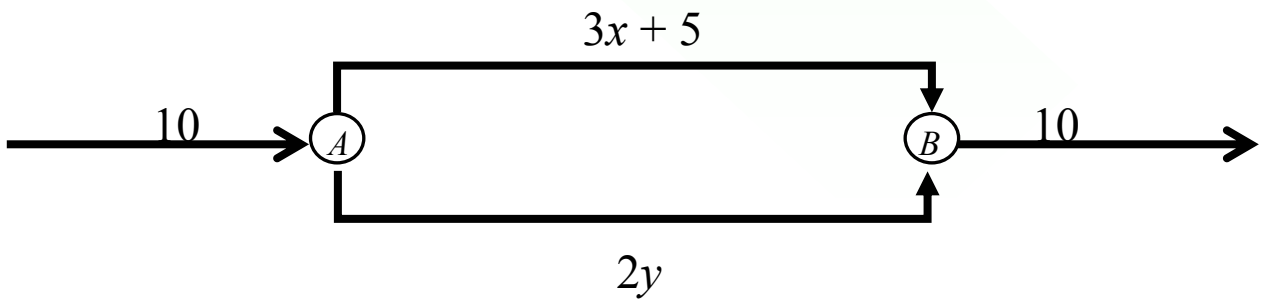
Competition on a road network

- **Road network: point *A* to point *B***
  - **10 Kusers**
  - **2 routes**
  - **travel time (“cost”) = *f*(# of users on route)**



Liberal Regulation

- Informed users choose the route according to travel times
- "Wardrope": equilibrium if
  - cost of two routes is equal
  - $3w + 5 = 2(10 - w) \Rightarrow w = 3$
  - 3 Kusers on upper route (cost = 14)
  - 10 – 3 = 7 Kusers on lower route (cost = 14)
- Each user "pays" 14
- Social "cost" = 140 (time lost in the network)



Bureaucratic Regulation

- **A bureaucrat located at *A* makes the choices for the users. He wishes to minimize social cost**

  $CT(w) = w(3w + 5) + 2(10 - w)^2 = 5w^2 - 35w + 200$

- **Minimization**

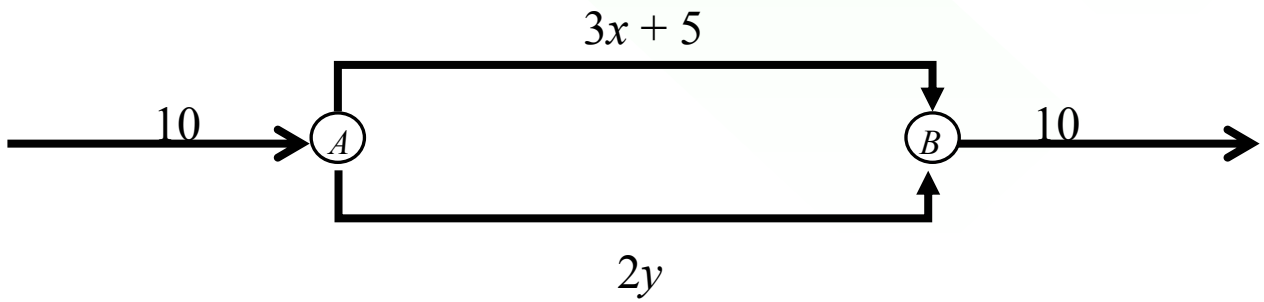
  $CT'(w) = 10w - 35 = 0 \Rightarrow w = 3{,}5$

  - **3,5 Kuser on upper route each paying:**

    $(3 \times 3{,}5 + 5) = 15{,}5$

  - **6,5 Kusers on lower route each paying:**
  - $2 \times 6{,}5 = 13$

- **Social cost = $3{,}5(3 \times 3{,}5 + 5) + 2(10 - 3{,}5)2 = 138{,}75$**
- **Efficiency *vs.* Justice ??**



Decision Analysis and Decision Theory