Using real option analysis to quantify the effects of ethanol policy on production
A PDE-based stochastic control approach

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Christian Maxwell
cmaxwel5@uwo.ca

Joint work with Matt Davison
University of Western Ontario

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Ethanol biofuel production in North America has grown in popularity due to environmental and economic reasons. It has become politically attractive to subsidize biofuel programs (ethanol in particular), however subject to much policy uncertainty.

Idea

Can real options and mathematical finance aid as a tool for policy analysis?

_Corn ethanol in a few words: You make money on the spread._
Assembling the model

A model for studying policy impact on ethanol production will require:

1. A model for the plant including flexibility control, capitalized construction costs, profit as a function of ethanol/corn, costs to pause/resume production
2. A stochastic model for corn and ethanol prices
3. An optimal operating rule which maximizes expected future profits
Management flexibility (control)

Depending on price conditions, management has the option to:

1. Enter into the investment with a capitalized cost of $B$ dollars per gallon of production capacity
2. Start or stop production depending on expected profitability (i.e. to avoid running at a loss over sustained periods and to recapture profits if price become favourable again)
   - To start production on from off costs a penalty $D_{01}$ dollars per gallon
   - To stop production incurs a penalty of $D_{10}$

The two main states are on (1) and off (0).
When in regime $i$ our running profit is $f_i(\ldots)$

1 bushel of corn produces $\kappa$ gallons of ethanol

$K_i$ is the fixed running cost per gallon in state $i$

While idle, the running costs are fixed $f_0 = -\kappa K_0$. 

\[
\text{corn} \rightarrow \text{ethanol} + \text{by-products}
\]

\[
\begin{align*}
\text{profit} &= \text{yield} \times \text{ethanol} + \text{subsidy} - \text{running costs} - \text{corn} \\
&= f_1(x_t) + s - p - K_1 - Y_t \\
\end{align*}
\]

\[
f_1 = \kappa(x_t - K_1) - Y_t
\]
Statistical tests found weak evidence for mean reversion or seasonality (Kirby & Davison, 2010), hence a joint GBM diffusion was chosen.

Ethanol: \( X_t \)
Corn: \( Y_t \)

\[
\begin{align*}
\frac{dX_t}{X_t} &= \mu dt + \sigma dW_{1t} \\
\frac{dY_t}{Y_t} &= \alpha dt + \beta dW_{2t} \\
\text{Corr}[W_{1t}, W_{2t}] &= \rho
\end{align*}
\]

Parameters were estimated using basic regression analysis.
Expected earnings

Total expected discounted earnings

\[
J_i(t, \alpha, x, y) = E \left[ \int_t^T e^{-r(s-t)} f_s(s, X_s, Y_s) ds - \sum_{k=1}^n e^{-r(\tau_k-t)} D_{i_{k-1}, i_k} \right]_{F_t}
\]

where \( \alpha = (\tau_k, i_k) \) is a switching control sequence between the on and off states

- \( t \leq \tau_k \leq T \) denotes an increasing sequence of stopping times (when to switch),
- and corresponding states \( i_k \) (where to switch),
- with \( l_t = \sum_{0 \leq k \leq n} i_k \mathbf{1}_{[\tau_k, \tau_{k+1})} \)

We assume the facility has no salvage value at the end of its useful life
\[ V_i(T, X_T, Y_T) = 0 \]
The value function in state $i$ at time $t$ assuming subsequent optimal control is $V_i(t, x, y) = \sup_{\alpha} J_i(t, \alpha, x, y)$.

Dynamic programming principle:

$$V_i(t, x, y) = \sup_{\tau} \mathbb{E} \left[ \int_t^{\tau} e^{-r(s-t)} f_i(s, X_s, Y_s) ds \right]$$

$$+ \max_{0 \leq j \leq m} e^{-r(\tau-t)} \left\{ V_j(\tau, X_\tau, Y_\tau) - D_{ij} \right\} 1_{\{\tau < T\}} \bigg| \mathcal{F}_t$$
Stochastic optimal control

Optimal choice

The value function in state $i$ at time $t$ assuming subsequent optimal control is $V_i(t, x, y) = \sup_{\alpha} J_i(t, \alpha, x, y)$.

Dynamic programming principle:

$$V_i(t, x, y) = \sup_{\tau} E \left[ \int_t^\tau e^{-r(s-t)} f_i(s, X_s, Y_s) ds \right.$$

$$\left. + \max_{0 \leq j \leq m} e^{-r(\tau-t)} \left\{ V_j(\tau, X_\tau, Y_\tau) - D_{ij} \right\} 1_{\{ \tau < T \}} \bigg| \mathcal{F}_t \right]$$

So either (A) it is optimal to stay in the current state $i$ and the PDE is satisfied $C_i$:

$$\frac{\partial V_i}{\partial t} + \mathcal{L}[V_i] + f_i(t, x, y) - rV_i = 0, \quad V_i \geq V_j - D_{ij}$$
**Optimal choice**

The value function in state $i$ at time $t$ assuming subsequent optimal control is $V_i(t, x, y) = \sup_{\alpha} J_i(t, \alpha, x, y)$.

Dynamic programming principle:

$$V_i(t, x, y) = \sup_{\tau} E \left[ \int_{t}^{\tau} e^{-r(s-t)} f_i(s, X_s, Y_s) ds \right]$$

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So either (A) it is optimal to stay in the current state $i$ and the PDE is satisfied $C_i$:

$$\frac{\partial V_i}{\partial t} + \mathcal{L}[V_i] + f_i(t, x, y) - rV_i = 0, \quad V_i \geq V_j - D_{ij}$$

or (B) it is optimal to switch $S_{ij}$

$$V_i = \max_{0 \leq j \leq m} V_j - D_{ij}$$

where $\mathcal{L}$ is the generator associated with the diffusion.
This is a system of free boundary PDEs (or linear complimentary problem)

**Variational inequalities**

\[
\max_{0 \leq j \leq m} \left[ (V_j - D_{ij}) - V_i \right] = 0
\]

where the generator \( \mathcal{L} \) is

\[
\mathcal{L} = \mu x \frac{\partial}{\partial x} + \frac{1}{2} \sigma^2 x^2 \frac{\partial^2}{\partial x^2} + \rho \sigma x b y \frac{\partial^2}{\partial x \partial y} + \frac{1}{2} b^2 y^2 \frac{\partial^2}{\partial y^2} + ay \frac{\partial}{\partial y}
\]

In other words:

\[
PDE \leq 0, \quad Constraint \leq 0, \quad PDE \times \text{constraint} = 0
\]
Entry into investment

Suppose the firm has a finite lease time on the green field site to build the facility. The decision to enter is analogous to an American call struck at $B$ on the potential future earnings (compound chooser option).

$$\max \left\{ \frac{\partial V}{\partial t} + \mathcal{L}[V] - rV, \max [V_1(x, y, t), V_0(x, y, t)] - B \right\} = 0$$
We call the values at the grid points $V(x_i, y_j, t_k) = V^k_{i,j}$

- $t_k = t_0 + k\Delta t$
- $x_i = x_0 + i\Delta x$
- $y_j = y_0 + j\Delta y$

$$\begin{align*}
\frac{\partial V}{\partial x} &\approx \frac{V_{i+1} - V_{i-1}}{2\Delta x} \\
\frac{\partial V}{\partial t} &\approx \frac{V_{i+1}^k - V_{i}^k}{\Delta t} \\
\frac{V^{k+1} - V^k}{\Delta t} + L V^k &+ f^k \leq 0 \\
\end{align*}$$

$L$=differentiation matrix

Leads to coupled linear complimentary problem

$$MV - b \leq 0, \quad V \geq g, \quad (MV - b)^T(V - g) = 0$$

where obstacle $g = V_* - D_*$, $b = -V^{k+1} - f^k$, $M = (\Delta t L - 1)$. 
Effects of $\rho$: lessons from exchange options

If there are no switching costs, then this is a running exchange option:

$$V(x, y, t) = E_{x, y} \left[ \int_t^T (\kappa X_s - Y_s)^+ \, ds \right]$$

which has solution

$$V(t, x, y) = \int_t^T e^{-r(s-t)} \left[ \kappa xe^{\mu(s-t)} \Phi(q_+) - ye^{a(s-t)} \Phi(q_-) \right] \, ds$$

where

$$q_\pm = \ln \left( \frac{\kappa xe^{\mu(s-t)}}{ye^{a(s-t)}} \right) \pm \frac{1}{2} \nu \sqrt{s-t}$$

$$\nu^2 = \sigma^2 - 2\rho \sigma b + b^2$$
Outline of policy investigation

We investigate the effects of:
- increased correlation
- increased corn prices
- reductions in ethanol subsidy

on the following:
- plant value
- operating characteristics
- decision to enter into investment

Figure: Level lines of ethanol $L$ vs corn $C$. 
Effects of $\rho$

Losses in value due to $\rho$ on a 10 year horizon problem.

**Figure:** 3-year rolling correlation Jan/04–Dec/11.

**Figure:** $V_i/V_{i,\text{ref}}$, the option loses much value as $rho$ increases.
As ethanol policy induces more players into the market, the projects become less valuable due to increased correlation between corn/ethanol driven by ethanolic biofuel production demand.

**Figure:** The switching boundaries vs $\rho$. Here we grouped $z = \frac{\text{ethanol}}{\text{corn}} = \frac{x}{y}$.

**Figure:** A contour plot of $\frac{\partial V_1}{\partial \rho}$. 

**Increased correlation**

**Loss in value and effects on operating decisions $\rho$**
Effects of subsidy policy on operation

**Figure:** Positive profits with/without subsidy using historical price series $1_{f_1} > 0$.

**Figure:** An operating signal using the historical realized price series in the absence of subsidy.
Effects of subsidy policy on entry into investment

**Figure**: A large number of projects are stalled in the absence of subsidy indicated by a spike at zero.

**Figure**: An investment signal using the historical realized price series in the absence of subsidy.
Policy uncertainty in ethanol subsidy

The level of subsidy has varied over the years. This subjects investment decisions to added uncertainty.

<table>
<thead>
<tr>
<th>Act</th>
<th>Year</th>
<th>Subsidy ($/gallon)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Energy Tax Act</td>
<td>1978</td>
<td>0.40</td>
</tr>
<tr>
<td>Surface Transportation Assistance Act</td>
<td>1983</td>
<td>0.50</td>
</tr>
<tr>
<td>Tax Reform Act</td>
<td>1984</td>
<td>0.60</td>
</tr>
<tr>
<td>Omnibus Budget Reconciliation Act</td>
<td>1990</td>
<td>0.54</td>
</tr>
<tr>
<td>1998 change effective 2001</td>
<td>2001</td>
<td>0.53</td>
</tr>
<tr>
<td>1998 change again effective 2003</td>
<td>2003</td>
<td>0.52</td>
</tr>
<tr>
<td>Extension to 2007 but reduced in 2005</td>
<td>2005</td>
<td>0.51</td>
</tr>
<tr>
<td>Farm Bill</td>
<td>2008</td>
<td>0.45</td>
</tr>
</tbody>
</table>

Can we account for this?

It is not easily hedged, but we can try model it stochastically...
Choose a simple Merton style jump model for the subsidy $S_t$

\[ dS_t = (J - S_t) dq, \quad J \sim \logN(a, b) \]

and $dq$ is a Poisson process with arrival rate $\lambda$

To simplify the analysis, group $\kappa X - Y$ into $Z$. Choose $Z$ to be a GBM and estimate parameters by shifting the series up by $z_{\text{min}}$.

\[
\text{profit} = \text{yield} \kappa (\text{ethanol} + \text{subsidy} - \text{running costs}) - \text{corn}
\]

\[
f = \kappa X_t - Y_t - \kappa p + \kappa S_t
\]

The profit function is then:

\[
f(Z_t, S_t) = Z_t - z_{\text{min}} - \kappa(p - S_t)
\]
The coupled control problem for the operator is given by PIDVI

$$\max \left( \frac{\partial V_i}{\partial t} + \mathcal{L}[V_i] + f_i(z, s) + \lambda E[V_i(J)] - (r + \lambda) V_i, \quad (V_j - D_{ij}) - V_i \right) = 0$$

To account for the integral, just discretize the sum and throw it into differentiation matrix:

$$E[V(x, J, t)] = \int_0^{S_{\text{max}}} V(z, s, t) g(s) ds = \sum_{j=0}^{S_{\text{max}}} V_{i,j}^k g(j \Delta S) \Delta S$$
A simple model

Value and decision boundaries

Here are the baseline cases at different subsidy levels. Recall

$$Z = \kappa X - Y$$

**Figure:** Values at different spreads and subsidies.

**Figure:** 1D switching boundaries overlaid onto 2D model:

$$X = \frac{1}{\kappa} (\theta + Y)$$
A simple model

Effects of policy uncertainty

Effects of uncertainty: Makes you switch ‘sooner’ and pushes value to ‘expected’ policy level.

Figure: Switching decisions with and without uncertainty.

Figure: Change in value

\[ V_{\text{risk}}(Z_t, s, t) - V_{\text{no risk}}(Z_t, S_t, t) \]
We were able to use real options analysis and stochastic control to

- quantitatively determine how price uncertainty affects operating decisions over life of facility (i.e. optimal switching/entry times)
- measurably assess how external policy factors affect these decisions and the economic viability of the facility

**Conclusion:**

Real options analysis is an insightful tool for studying energy policy.

*Thank you!*
Model Extensions:

**ABANDONMENT:**
If the option to abandon exists, this limits the potential losses to the salvage value \( F \) at abandonment.

\[
\max \left[ \frac{\partial V_0}{\partial t} + L[V_0] + f_0 - rV_0, \max \{(V_1 - D_{01}) - V_0, F\} \right] = 0
\]

**STOCKPILING:**
Possibility of stockpiling corn during “low” corn prices. Adds complexity in terms of determining optimal rate to
- purchase (stockpile) excess corn during low prices
- consume corn stockpile during high corn prices

The result is to reduce the need to ever pause production and increases the overall facility value.