



THE UNIVERSITY OF TEXAS AT AUSTIN
McCOMBS SCHOOL OF BUSINESS

Decision Trees 2

Lecture 7

STA 371G

Announcement: Midterm 1

- Midterm 1 is on February 22 or 23, in the ModLab
- You'll be able to bring one page of notes to use during the exam
- You'll also have access to R

Announcement: Midterm 1 signup

On Thursday at 7 PM, you'll get a link to sign up for a time to take Midterm 1 in the ModLab. You can pick any of the following times, but sign up ASAP as space is limited!

- Thursday, February 22 @ 5:00 PM
- Thursday, February 22 @ 6:45 PM
- Friday, February 23 @ 8:00 AM
- Friday, February 23 @ 9:45 AM
- Friday, February 23 @ 11:30 AM
- Friday, February 23 @ 1:15 PM

Announcement: Perusall due dates

Perusall due dates have all been pushed back by a day (for the Tuesday/Thursday sections) but try to still complete by 7 PM the night before class, if possible

Oil drilling

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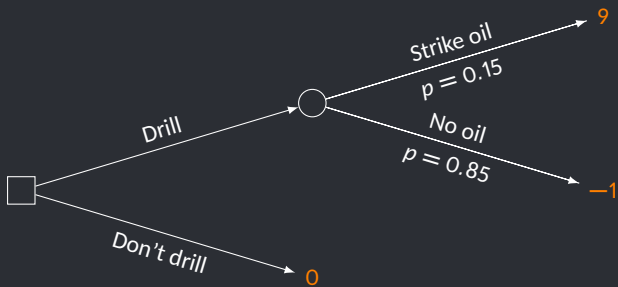
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- If you strike oil, you will generate \$10M.

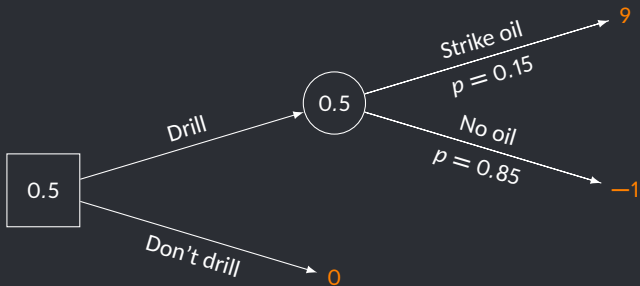


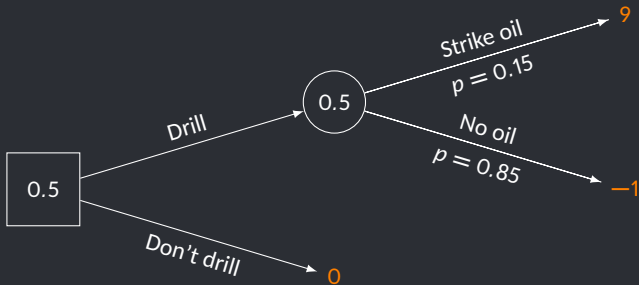
Oil drilling

- Suppose you are planning to drill for oil in a newly-discovered field.
- Setting up the drilling equipment costs \$1M.
- If you strike oil, you will generate \$10M.
- But there's only a 15% chance that a random oil field has oil.









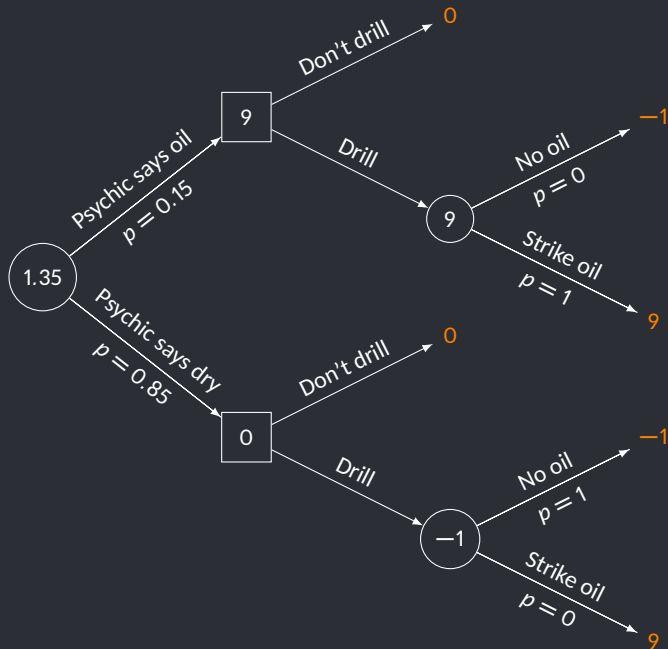
Without any information, we expect to make \$0.5M by deciding to drill.

How much is perfect information worth?

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- The psychic is always right!



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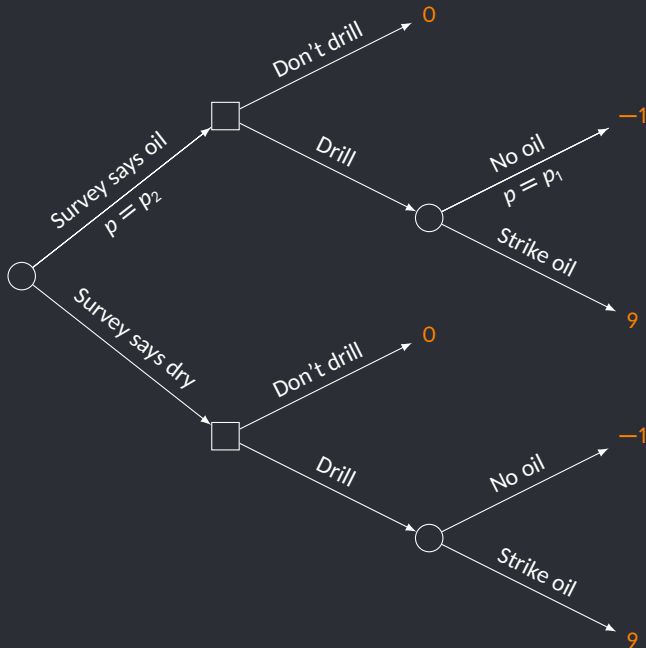


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- How much should we be willing to pay for the survey?





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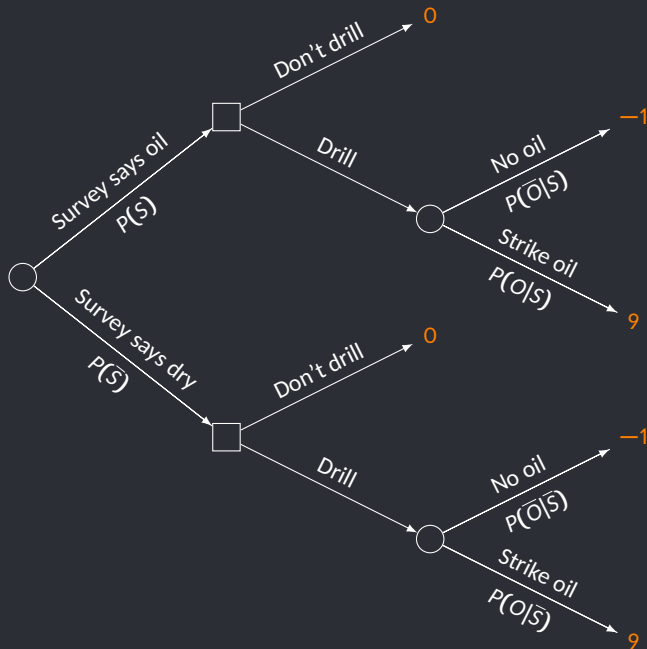
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$$P(S|\overline{O}) = 0.2, \quad P(\overline{S}|\overline{O}) = 0.8$$



Let's calculate the required probabilities using Bayes' rule:

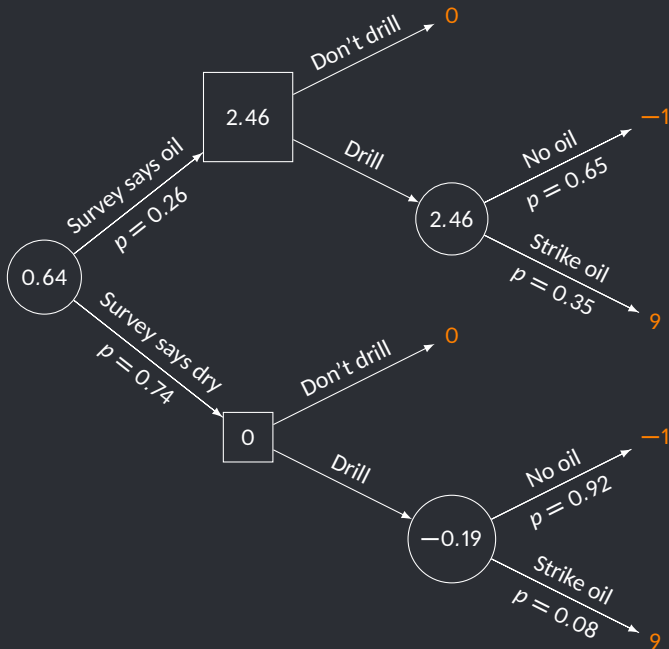
$$\begin{aligned}P(O|S) &= \frac{P(S|O)P(O)}{P(S|O)P(O) + P(S|\bar{O})P(\bar{O})} \\&= \frac{(0.6)(0.15)}{(0.6)(0.15) + (0.2)(0.85)} \\&= 0.35\end{aligned}$$

$$\begin{aligned}P(\bar{O}|S) &= \frac{P(S|\bar{O})P(\bar{O})}{P(S|\bar{O})P(\bar{O}) + P(S|O)P(O)} \\&= \frac{(0.2)(0.85)}{(0.2)(0.85) + (0.6)(0.15)} \\&= 0.65\end{aligned}$$



We also need to know the probability that the survey will indicate oil:

$$\begin{aligned}P(S) &= P(S \text{ and } O) + P(S \text{ and } \bar{O}) \\&= P(S|O)P(O) + P(S|\bar{O})P(\bar{O}) \\&= (0.6)(0.15) + (0.2)(0.85) \\&= 0.26\end{aligned}$$

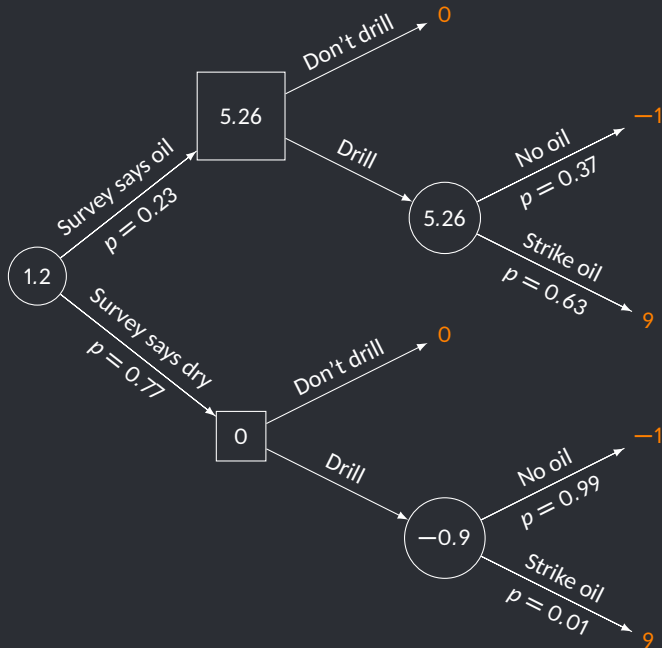


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- Suppose we had a better survey, which correctly identifies oil-rich fields 95% of the time, and correctly identifies dry fields 90% of the time.





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 - No survey (or any other kind of information about this oil field) could ever be worth more than \$0.85M.
- With imperfect information (the better survey), the expected value of the tree was \$1.2M. The EVSI (expected value of sample information) is $1.2 - 0.5 = \$0.7\text{M}$.
 - It's worth paying up to \$0.7M for this particular survey.