

Homework #2

1) Consider the problem of an oil company that wants to maximize profits from an oil well.

Revenue at time t is given as, $R_t = p_t \cdot u_t$.

Where p_t is the price of oil at t , and where u_t is the amount of oil that is extracted and sold. The

company's cost function is quadratic in the amount of oil that is extracted, $C_t = 0.05 u_t^2$.

The amount of oil remaining in the well follows the recursion or transition equation, $x_{t+1} = x_t - u_t$,

where x_t is known as state variable in dynamic programming language. The company applies the

discount factor $\beta = 0.9$ for profit streams that occur in the future. We also assume that the

company intends to have the oil well depleted in 2 years and let the initial date be $t = 0$, which

means that $x_2 = 0$. Therefore, the above problem can also be stated as follows,

$$\text{Maximize} \quad \sum_{t=0}^1 \beta^t (p_t u_t - 0.05 u_t^2),$$

$$\text{Subject to,} \quad x_{t+1} = x_t - u_t, \quad \text{for } t = 0, 1, \quad \text{and} \quad x_2 = 0$$

Then, solve the above problem for optimal policy rules, u_t for $t = 0$ and 1 , with the help of the

Bellman equations.