From Stream Flows to Cash Flows: Leveraging Evolutionary Multi-Objective Direct Policy Search to Manage Hydrologic Financial Risks

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Key Points:

- Reservoir control and financial risk management share a common multi-objective decision structure and can be optimized using similar methods
- Evolutionary Multi-Objective Direct Policy Search (EMODPS) is used to develop financial risk management policies for a hydropower producer
- Information theoretic sensitivity analysis and visual analytics are used to build intuition about how policies adapt to changing conditions

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Abstract

Hydrologic variability can present severe financial challenges for organizations that rely on water for the provision of services, such as water utilities and hydropower producers. While recent decades have seen rapid growth in decision-support innovations aimed at helping utilities manage hydrologic uncertainty for multiple objectives, support for managing the related financial risks remains limited. However, the mathematical similarities between multi-objective reservoir control and financial risk management suggest that the two problems can be approached in a similar manner. This paper demonstrates the utility of Evolutionary Multi-Objective Direct Policy Search (EMODPS) for developing adaptive financial risk management policies in the context of hydropower production in a snow-dominated region. These policies dynamically balance a portfolio, consisting of snowpack-based financial hedging contracts, cash reserves, and debt, based on evolving system conditions. Performance is quantified based on four conflicting objectives, representing the classic tradeoff between "risk" and "return" in addition to decision-makers' unique preferences towards different risk management instruments. The dynamic policies identified here significantly outperform static management formulations that are more typically employed for financial risk applications in the water resources literature. Additionally, this paper combines visual analytics and information theoretic sensitivity analysis to help decision-makers better understand how different candidate policies achieve their comparative advantages through differences in how they adapt to real-time information. The methodology developed in this paper should be applicable to any organization subject to financial risk stemming from hydrology or other environmental variables (e.g., wind speed, insolation), including electric utilities, water utilities, agricultural producers, and renewable energy developers.

Keywords

Hydropower, water resources, snow, financial risk, decision support, uncertainty

1 Introduction

Reservoir control and financial risk management share strong similarities. The principal task in each is to reduce the risk of negative impacts from variable inflows (either hydrologic flows or cash flows), through the use of a buffer stock (either a reservoir or a reserve fund) that is filled in times of abundance and drawn down in times of scarcity

(Figure 1). Other risk management tools may also be used to limit the impact of low-flow periods, but at a cost (e.g., water desalination or demand management for streamflow deficits, and borrowing or financial hedging for cash flow deficits). In both cases, the manager must make decisions under an array of uncertainties, and may need to navigate tradeoffs between conflicting objectives (e.g., flood control vs. water supply for reservoir control, risk vs. cost for financial risk management). And in both cases, as systems dynamically evolve, managers will have to adapt to new information as it becomes available. In other words, reservoir control and financial risk management can be formulated as very similar Markov Decision Processes (MDPs) (Bertsekas, 2019; Powell, 2019), whether managers attempt to solve this problem explicitly, using programmatic approaches such as stochastic dynamic programming, or implicitly, relying on expert specified rules. Additionally, reservoir control and financial risk management are strongly interdependent activities for water-reliant organizations in the Food-Energy-Water Nexus, such as hydropower producers, municipal water utilities, and irrigation districts (Cai, Wallington, Shafiee-Jood, & Marston, 2018; D'Odorico et al., 2018; Scanlon et al., 2017). Such organizations rely on water for the provision of services, and as a result, their revenues and/or costs can be highly dependent on hydrologic inflows (Blomfield & Plummer, 2014; Larson, Freedman, Passinsky, Grubb, & Adriaens, 2012). This suggests that an understanding of complex water resource system dynamics can be used to better characterize and adaptively manage financial risks borne by water-reliant organizations.

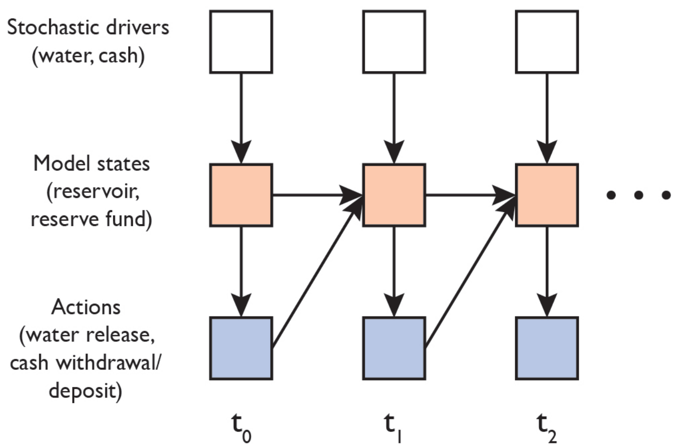

Figure 1. A simple reservoir model and a simple cash flow model share the same underlying decision structure.

Water resource systems researchers have developed a broad range of strategies for dynamically managing reservoir operations in the face of uncertain hydrometeorology and demands (see reviews by Castelletti, Pianosi, and Soncini-Sessa (2008); Labadie (2004); Macian-Sorribes and Pulido-Velazquez (2019); Yeh (1985)), but Stochastic Dynamic Programming (SDP) and its many derivatives have been the most popular. The problem is formulated as an MDP in which a decision-maker (DM) must make sequential decisions based on the stochastically evolving state of the system. Each action affects the immediate cost/reward as well as the future state of the system. In SDP, this recursion is used to find optimal operating rules, in the form of a discrete policy table, using the Bellman Equation (Bellman, 1957). However, despite its widespread use, SDP suffers from a number of limitations that reduce its applicability to large, complex, multi-objective problems where operations are evaluated using stochastic simulations (see discussion in Giuliani, Castelletti, Pianosi, Mason, and Reed (2016)).

A variety of approximation methods have been developed to overcome these challenges, such as approximate dynamic programming, reinforcement learning, and model predictive control (Bertsekas, 2019). Direct Policy Search (DPS) (Rosenstein & Barto, 2001), or parameterization-simulation-optimization (Koutsoyiannis & Economou, 2003), has become increasingly popular in the field of water resources systems analysis (Macian-Sorribes & Pulido-Velazquez, 2019). DPS is an approximation in policy space (Powell, 2019), wherein the optimal operating policy is assumed to lie in the space of a certain parametric family of functions, and the policy parameters are optimized rather than the decisions themselves (i.e., optimizing state-aware adaptive rule systems instead of specific actions). This drastically reduces the "curse of dimensionality" that limits the tractability of large SDP problems. Additionally, DPS allows for "model-free" representation of stochastic inputs, meaning that observational data, synthetically generated data, and process-based simulation model output can all be used in lieu of explicit probability distributions (Desreumaux, Côté, & Leconte, 2018; Giuliani, Quinn, Herman, Castelletti, & Reed, 2018). A simulation-based approach to optimization also allows for flexible construction of mixed multi-objective formulations (Giuliani et al., 2016; Kasprzyk, Reed, & Hadka, 2016; Quinn, Reed, & Keller, 2017). In Evolutionary Multi-Objective Direct Policy Search (EMODPS) (Giuliani, Herman, Castelletti, & Reed, 2014), the policies are parameterized with a non-linear approximating network and optimized using a multi-objective evolutionary algorithm (MOEA). EMODPS has been deployed to solve complex reservoir operations problems (multiple reservoirs; multiple, mixed objectives; and model-free information) that would be untenable using a traditional SDP approach (Denaro, Anghileri, Giuliani, & Castelletti, 2017; Giuliani, Pianosi, & Castelletti, 2015; Quinn et al., 2018; Zatarain Salazar, Reed, Quinn, Giuliani, & Castelletti, 2017).

To complement algorithmic search strategies, water resources researchers have developed an assortment of computational tools to help DMs better understand their options. This is especially important in multi-objective contexts, where optimization results in a multitude of solutions representing the optimal tradeoffs between conflicting objectives (the Pareto set), rather than a single "best" policy. As the dimensionality of the Pareto set grows, it becomes increasingly difficult to conceptualize. High-dimensional visualization, solution brushing, and other visual analytic techniques can help DMs to better understand the complex tradeoffs in their system and choose the solution that best suits their needs (Herman, Zeff, Reed, & Characklis, 2014; Huskova, Matrosov, Harou, Kasprzyk, & Lambert, 2016; Kollat & Reed, 2007). These tools can also help DMs to refine their conceptualization of the problem at hand through iterative problem reformulation (Castelletti & Soncini-Sessa, 2006; Giuliani, Herman, et al., 2014; Kasprzyk, Reed, Characklis, & Kirsch, 2012). Visual analytics are especially powerful when combined with global sensitivity analyses that probe the impacts of key uncertainties on system performance (Iooss & Lemaître, 2015; Pianosi et al., 2016; Saltelli, Tarantola, & Campolongo, 2000). These tools can be used to "open the black box" of non-linear approximating networks and help DMs to better understand how the optimal operating policies adapt to changing conditions (Quinn, Reed, Giuliani, & Castelletti, 2019). In this way, visual analytics and sensitivity analysis can help to build trust between water resources modelers and real-world stakeholders (Basdekas, 2014; Brown et al., 2015), a crucial element in the production of actionable knowledge (Caniglia et al., 2020; Cash et al., 2003).

Water-reliant organizations such as water utilities and hydropower producers rely on water for the provision of services, so that water or power sales may be significantly diminished during a drought (Hughes et al., 2014; Larson et al., 2012). This can result in severe cash flow deficits that leave an organization at risk of defaulting on its obligations (e.g., debt service, operations and maintenance) (Ceres, 2017; Hughes & Leurig, 2013; Leurig, 2010). Water utilities and hydropower-reliant power utilities are therefore vulnerable to significant financial disruption during drought, and hydrologic financial risk can have an outsized impact on the long-term viability of the utility; indeed, credit rating agencies have noted that the ability to manage the financial impacts of drought is an important factor in determining a utility's creditworthiness (Chapman & Breeding, 2014; Moody's Investors Service, 2011, 2019). Financial risk management tools, such as reserve funds, financial hedging contracts, and lines of credit, can reduce the variability in net cash flows. This, in turn, can reduce an organization's likelihood of bankruptcy, improve its credit rating, and reduce its future borrowing costs (Bank & Wiesner, 2010; Pérez-González & Yun, 2013), in addition to helping risk-averse staff feel more comfortable (Bodnar, Giambona, Graham, & Harvey, 2019; Krause & Tse, 2016).

Despite the critical role of financial risk management in water resources, decision support for practitioners in this area has remained limited. There is a long history of considering financial objectives such as expected revenues and costs in water resources systems analysis (e.g., see references in Labadie (2004); Macian-Sorribes and Pulido-Velazquez (2019); Yeh (1985)). However, fewer studies have explicitly accounted for variability in costs and revenues, or the financial risk management actions that an organization can take to combat this variability. Those that do have tended to propose static, non-adaptive management strategies. For example, the literature on using hydrology-based index contracts to hedge exposure to drought has generally assumed that the same hedging contract is purchased each year, not allowing for risk management to be adjusted over time as conditions change; applications include hydropower (Foster, Kern, & Characklis, 2015; Hamilton, Characklis, & Reed, 2020; Meyer, Characklis, Brown, & Moody, 2016), water supply (Brown & Carriquiry, 2007; Maestro, Barnett, Coble, Garrido, & Bielza, 2016; Zeff & Characklis, 2013), and agriculture (Denaro, Castelletti, Giuliani, & Characklis, 2020; Mortensen & Block, 2018; Turvey, 2001). Modeling of financial reserves is not common in the water resources literature, and the limited examples tend to assume that the utility will contribute either a fixed amount or a fixed fraction of revenues to the reserve fund each year (Rehan, Knight, Unger, & Haas, 2013; Rehan, Unger, Knight, & Haas, 2015; Zeff, Kasprzyk, Herman, Reed, & Characklis, 2014).

However, financial researchers have demonstrated that adaptive, state-aware action is crucial to financial risk management (Bolton, Chen, & Wang, 2011; Disatnik, Duchin, & Schmidt, 2014; Froot, Scharfstein, & Stein, 1993; Rampini, Sufi, & Viswanathan, 2014). Just as a reservoir operator should consider current reservoir levels and expected future inflows when making release decisions, so should a financial risk manager consider the utility's current bank account balance and projected future revenues and costs when deciding whether to withdraw money from the bank, or whether to hedge its drought exposure using index contracts. A variety of optimization methods have been applied to financial problems such as investment portfolio selection (Markowitz, 1952; Mulvey, 2001; Pardalos, Sandström, & Zopounidis, 1994), asset-liability management (Kouwenberg & Zenios, 2008; Sodhi, 2005), and cash flow management (Baumol, 1952; da Costa Moraes, Nagano, & Sobreiro, 2015; Miller & Orr, 1966). As in water resources systems analysis, some researchers in finance have moved towards multi-objective formulations (Salas-Molina, Pla-Santamaria, & Rodriguez-Aguilar, 2018; Spronk, Steuer, & Zopounidis, 2005; Zopounidis, Galariotis, Doumpos, Sarri, & Andriosopoulos, 2015), model-free information (Sun, Fang, Wu, Lai, & Xu, 2011), heuristic solution methods (da Costa Moraes & Nagano, 2013; Ponsich, Jaimes, & Coello Coello, 2013; Tapia & Coello Coello, 2007), and visual analytics (Flood, Lemieux, Varga, & William Wong, 2016; Savikhin, Lam, Fisher, & Ebert, 2011), in order to provide more meaningful decision support for practitioners in the financial sector (Steuer, Qi, & Hirschberger, 2007; Zopounidis, Doumpos, & Niklis, 2018). However, decision support remains limited for actors outside of the financial sector, such as water and power utilities, who nevertheless face significant financial risks.

This paper bridges the gap between reservoir control and financial risk management to show how computational tools developed for the former can be adapted to the latter in coupled water resource systems. This research builds on prior work by the authors dealing with drought-related financial risk management by a hydropower producer in a snow-dominated region. First, Hamilton et al. (2020) developed a hydro-financial simulation model that abstracts the hydroclimatology, hydropower generation, cash flows, and financial risk management of the Power Enterprise of the San Francisco Public Utilities Commission (SFPUC). The authors used this model to evaluate different static financial risk management portfolios within a Monte Carlo framework and search for optimal portfolios using an MOEA. In related work, Gupta, Hamilton, Reed, and Characklis (2020) introduced an adaptive EMODPS formulation of a simplified financial risk management problem, which was used to diagnostically benchmark if modern MOEAs are capable of addressing this new class of problem. The present study builds on these prior works by contributing the most detailed and actionable representation to date of how EMODPS can be used to craft operating policies that adapt to changing conditions over time when managing drought-related financial risk. The advantages of dynamic decision-making are demonstrated relative to a simplified static operating policy akin to those commonly applied to financial risk management in the water resources literature. This paper also demonstrates the value of higher-dimensional problem framings that explicitly account for DM preferences with respect to the use of different management tools. Lastly, a framework is contributed for combining *a posteriori* visual analytics with information theoretic sensitivity analysis (ITSA) in order to help DMs better understand how complex, non-linear operating policies achieve their goals by adapting to real-time information when making decisions.

2 Study context

2.1 Study area

San Francisco Public Utilities Commission (SFPUC) owns and operates three reservoirs (Hetch Hetchy Reservoir, Cherry Lake, and Lake Eleanor) in the upper Tuolumne River basin in the Sierra Nevada mountains (Figure S1 in Supporting Information (SI)). These reservoirs deliver drinking water to much of the San Francisco Bay area, and en route, the water also provides hydroelectric power. SFPUC uses this hydropower to sell retail electricity at fixed rates to San Francisco International Airport, municipal buildings in San Francisco, and a number of other retail customer classes within the Bay area. Irrigation districts along the Tuolumne River also have the right to buy surplus hydropower, when available, at a fixed rate. When hydropower production is in excess of retail and irrigation district demands, it is sold at floating market rates into the Western Systems Power Pool (hereafter "wholesale market"). On the other hand, when hydropower is insufficient to meet the demand from retail customers, SFPUC is obligated to purchase the remainder on the wholesale market (San Francisco Public Utilities Commission, 2016).

2.2 Hydro-financial simulation model

The hydro-financial simulation model from Hamilton et al. (2020) consists of three types of variables which are updated at an annual time step: stochastic drivers, actions, and model states (Figure 2). The stochastic drivers are derived from a million-year synthetic dataset that links monthly snow water equivalent depth (SWE), hydropower generation, wholesale power price, and hydropower net revenue, and is found to closely match the historical record, while providing a wider sampling of possible outcomes than can be found in the limited historical data (Hamilton et al., 2020).

Three annual quantities are derived from this monthly synthetic dataset and used as stochastic drivers for the present study. Firstly, the SWE index (ε^S, in inches) is a weighted average of February and April SWE observations. The inflows to SFPUC's reservoirs are dominated by the seasonal dynamics of snow accumulation and melt, so SWE measurements taken upstream of the reservoirs in the late winter/early spring can be used to predict the magnitude of streamflows when the snow melts in the late spring/early summer. Subsequently, the weighted average SWE index is highly correlated with annual hydropower production and can be used to design index contracts used for financial hedging (see below). The second stochastic driver is hydropower net revenue (ε^R, in \$M), defined as the total annual cash flow resulting from retail and wholesale hydropower sales, minus wholesale power purchases, minus the annual "fixed costs" (debt service payments, operations and maintenance, salaries, etc.) that must be paid each year. Lastly, the power price index (ε^P, in \$/MWh) takes advantage of autocorrelation in the wholesale power market to predict (using linear regression) whether wholesale power prices over the coming water year will be favorable or unfavorable for the utility's net hydropower revenues. This index thus provides valuable information for making decisions regarding financial risk, and is used as one of the inputs to the dynamic control policies (Section 3.1.2). For more details on the monthly synthetic records and the calculation of ε^S and ε^R, see Hamilton et al. (2020). For more details on the calculation of ε^P, see SI Section S1.

Absent any financial risk management, the utility will experience years in which costs outweigh revenues (i.e., net revenue is negative). This situation can be extremely disruptive because the utility risks defaulting on its obligations (e.g., debt service or operations and maintenance). The utility has three financial risk management tools which can be used to avoid such negative outcomes. Firstly, They can purchase a snowpack-based hedging contract called a capped Contract for Differences (CFD). The CFD (SI Figure S2) provides payouts to the utility in low-SWE years (below 24.7 inches), when it expects to have low hydropower and thus low revenue, in return for the utility making payments in high-SWE years (above 24.7 inches), when the utility expects to have abundant hydropower and surplus revenue. The negative correlation between hydropower revenue and CFD payout has been found to significantly reduce the volatility of the com-

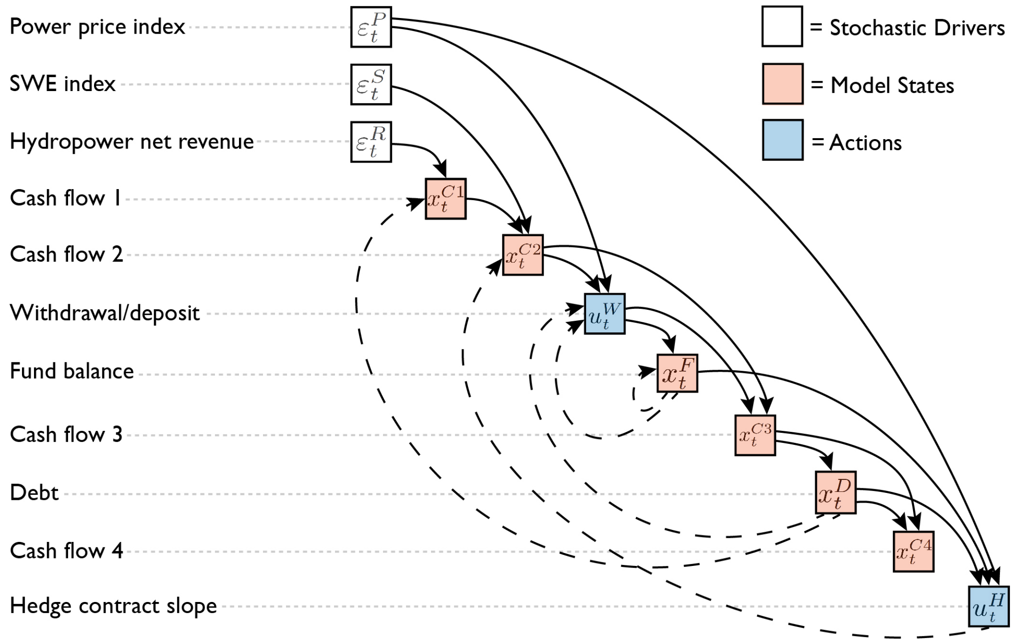

Figure 2. Annual sequence of operations in hydro-financial simulation model (moving from top left to bottom right). Solid (dashed) arrows represent the information flows from the current (previous) time step.

bined cash flow, suggesting its value as a financial risk management tool (Hamilton et al., 2020). The second risk management tool is a reserve fund, into which the utility can deposit surplus cash flows. This allows them to withdraw from the fund when hydropower revenues are insufficient to pay their bills. Lastly, the utility has a letter of credit with a bank, under which they can borrow money (i.e., issue short-term debt). The debt is paid back each year (with interest), and is assumed to take up the slack in situations where the other two tools fail to generate sufficient cash flows to avoid defaulting on the utility's obligations. Note that the short-term debt considered in this model is distinct from longer-term debt service obligations related to past bond offerings, typically associated with infrastructure investments, and which are assumed to be part of the "fixed costs" above.

Figure 2 shows how these financial operations are abstracted in the hydro-financial simulation model (See Table 1 for a list of variable names, symbols, units, and constants). The sequence of operations occurs at the end of each water year, September 30, based on the stochastic outcomes that occur over the course of that water year, ε_t. Two state-aware "actions" each year are governed by the control policy (to be described in Section

3.1): the amount of cash withdrawn from/deposited to the reserve fund (u_t^W, in \$M, where $u_t^W > 0$ represents a withdrawal and $u_t^W < 0$ represents a deposit), and the hedging contract slope (u_t^H, in \$M/inch of SWE). All other variables ("model states") are automatically updated according to the following rules:

$$
\begin{aligned}
x_t^{C1} &= \varepsilon_t^R - r^D x_{t-1}^D && (1)\\
x_t^{C2} &= x_t^{C1} + u_{t-1}^H h\left(\varepsilon_t^S\right) && (2)\\
x_t^F &= r^F x_{t-1}^F - u_t^W && (3)\\
x_t^{C3} &= x_t^{C2} + u_t^W && (4)\\
x_t^D &= \max(-x_t^{C3}, 0) && (5)\\
x_t^{C4} &= x_t^{C3} + x_t^D && (6)
\end{aligned}
$$

where x_t^{C1}, x_t^{C2}, and x_t^{C3} are intermediate cash flows and x_t^{C4} is the final cash flow in year t; x_t^D and x_t^F are the short-term debt and reserve fund balance at the end of time step t; r^D and r^F are the annual real interest rates on debt and reserves; and $h\left(\varepsilon_t^S\right)$ is the CFD payout function (SI Figure S2). This function converts the stochastic SWE index value from the current year into a number of inches of SWE for which the utility will receive compensation (if $h\left(\varepsilon_t^S\right) > 0$) or owe payment (if $h\left(\varepsilon_t^S\right) < 0$). To get the utility's total payout received (or payment due), this output is multiplied by the CFD slope, u_{t-1}^H, as chosen by the control policy at the end of the previous year (Section 3.1). The reader is referred to Hamilton et al. (2020) for more details on construction of the CFD.

A full realization of the hydro-financial simulation model requires iterating this sequence for $T = 20$ years, subject to a randomly sampled $(T+1)$-year sequence of stochastic drivers. The multi-year simulation accounts for the path-dependent dynamics of the reserve fund and debt, as well as the autocorrelation within the stochastic power prices. The reserve fund and debt are assumed to be zero at $t = 0$ (although in practice these values could be reset based on circumstance). The hedging contract policy in year 0 (the slope to be used for the payout in year 1) is calculated using x_0^F, x_0^D, and ε_0^P.

3 Methods

3.1 Control formulations

Within the hydro-financial simulation model, there are two important decisions that must be made each year: the hedging contract slope and the withdrawal from/deposit

Table 1. Variables and constants for hydro-financial simulation model.

Variable	Symbol	Value	Units
Power price index	ε_t^P	-	\$/MWh
SWE index	ε_t^S	-	inches
Annual net revenue	ε_t^R	-	\$M
Cash flow 1	x_t^{C1}	-	\$M
Cash flow 2	x_t^{C2}	-	\$M
Withdrawal	u_t^W	-	\$M
Reserve fund balance	x_t^F	-	\$M
Cash flow 3	x_t^{C3}	-	\$M
Debt	x_t^D	-	\$M
Cash flow 4	x_t^{C4}	-	\$M
Hedge contract slope	u_t^H	-	\$M/inch
Mean net revenue before risk management	$\bar{R}$	10.99	\$M
Real discount rate	r^A	0.9615	-
Real interest rate on fund	r^F	0.9825	-
Real interest rate on debt	r^D	1.0100	-
Time horizon	T	20	years
Debt sustainability constraint	ϵ	0.05	\$M
Normalization for power price index	k^P	350	\$/MWh
Normalization for hedge contract slope	k^H	4	\$M/inch
Normalization for revenues & cash flows	k^R	250	\$M
Normalization for fund & debt	k^F	150	\$M

to the reserve fund. A control policy refers to a structured set of rules for making these two decisions each year. This study introduces two types of control: static (or open-loop) policies, which perform the same actions with each time step (Section 3.1.1), and dynamic (or closed-loop) policies, which adapt to changing conditions over time (Section 3.1.2). Dynamic policies are considered state-aware because the decisions at each time step are conditioned on the current state of the model. Under both static and dynamic formulations, a policy is defined by a parameter vector which governs its operations. Multi-objective evolutionary optimization (Section 3.3) will be used to search for parameter vectors that perform well across four important objectives (Section 3.2).

3.1.1 Static policies

The static control formulation (adapted from Hamilton et al. (2020)) is given by:

$$\boldsymbol{\theta}_{stat} = [u^H, x^F_{max}] \tag{7}$$

where $\boldsymbol{\theta}_{stat}$ is the policy parameter vector and u^H and x^F_{max} are the two parameters to be optimized. u^H is the CFD slope, which is held fixed across all years in the simulation, while x^F_{max} is the maximum allowable reserve fund. Given x^F_{max}, the reserve fund operates according to the following simple rules: If the intermediate cash flow is negative ($x^{C2}_t < 0$), cash is withdrawn from the reserve fund to make up the deficit if possible. If $x^{C2}_t > 0$, the surplus is deposited into the fund, up until the fund has reached x^F_{max}. This policy is referred to as "static" because the CFD slope does not react to changing conditions (i.e., it is not state-aware). Although the withdrawal policy is quasi-state-aware via cash-balance constraints (money can neither be created nor destroyed), it is not truly dynamic in a meaningful sense (e.g., it cannot condition its reserve fund target on power price projections). Note that in Figure 2, the static formulation does not include the three input arrows into u^H_t, and only includes the two input arrows into u^W_t that relate to the cash balance constraints (x^{C2}_t and x^F_{t-1}).

3.1.2 Dynamic policies using Direct Policy Search (DPS)

The dynamic control formulation conditions the decision at each time step on the information available at that time. For a decision $u^{\mathcal{D}}_t$, with $\mathcal{D} \in \{W, H\}$ representing the withdrawal and hedging decisions, respectively:

$$u^{\mathcal{D}}_t = \mathcal{P}^{\mathcal{D}}(\boldsymbol{\mathcal{I}}^{\mathcal{D}}_{t'} | \boldsymbol{\theta}^{\mathcal{D}}_{dyn}) \tag{8}$$

where $\mathcal{P}^{\mathcal{D}}$ is the mathematical form of the policy for decision $\mathcal{D}$ (e.g., discrete policy table for SDP), $\boldsymbol{\theta}^{\mathcal{D}}_{dyn}$ is the vector of parameters to be optimized for the policy, and $\boldsymbol{\mathcal{I}}^{\mathcal{D}}_{t'}$ is the information upon which the decision is conditioned. This information can be any subset of the model states, actions, and stochastic drivers. The subscript t' on each element represents either the current (t) or previous ($t-1$) time step, based on the sequential nature of decisions (see Figure 2).

In DPS, $\mathcal{P}$ is assumed to be a family of parametric functions (Rosenstein & Barto, 2001). This approximation drastically reduces the number of decision variables in the search relative to SDP (Bertsekas, 2019; Powell, 2019). Many parametric function families are available (e.g., piecewise linear, polynomial, artificial neural network), but radial basis functions (RBFs) have been shown to be efficient universal approximators for DPS (Giuliani, Mason, Castelletti, Pianosi, & Soncini-Sessa, 2014). In this work, a sum of RBFs is paired with a constant shift parameter, along with an outer function that performs operations such as normalization and constraints. Equation 8 can be rewritten as:

$$u_t^{\mathcal{D}} = \phi^{\mathcal{D}}\left(a^{\mathcal{D}} + \sum_{m=1}^{M} w_m^{\mathcal{D}} \varphi_m\left(\boldsymbol{\mathcal{I}}_{t'}^{\mathcal{D}}\right)\right) \tag{9}$$

where $\phi^{\mathcal{D}}$ is the outer function, $a^{\mathcal{D}} \in [-1, 1]$ is a constant shift, and $w_m^{\mathcal{D}}$ is the weight given to the mth out of M total RBFs, φ_m. The weights must be chosen such that $\sum_{m=1}^{M} w_m^{\mathcal{D}} = 1$, and $w_m^{\mathcal{D}} \geq 0$ for all m. The RBF is defined

$$\varphi_m(\boldsymbol{\mathcal{I}}_{t'}^{\mathcal{D}}) = \exp\left(-\sum_{l=1}^{L} \frac{\left(\left[\boldsymbol{\mathcal{I}}_{t'}^{\mathcal{D}}\right]_l - c_{l,m}\right)^2}{(b_{l,m})^2}\right) \tag{10}$$

where $\left[\boldsymbol{\mathcal{I}}_{t'}^{\mathcal{D}}\right]_l$ is the lth out of L informational inputs, and $c_{l,m} \in [-1, 1]$ and $b_{l,m} \in (0, 1]$ are the center and radius, respectively, of the mth RBF in the direction of the lth input. The M RBFs are shared by the two decisions in the control policy.

The information vector for each decision includes the combination of state variables and external drivers that might be useful for making the decision:

$$\boldsymbol{\mathcal{I}}_{t'}^{W} = \left[r^F \tilde{x}_{t-1}^F, \quad r^D \tilde{x}_{t-1}^D, \quad \tilde{\varepsilon}_t^P, \quad \tilde{x}_t^{C2}\right] \tag{11}$$

$$\boldsymbol{\mathcal{I}}_{t'}^{H} = \left[\tilde{x}_t^F, \quad \tilde{x}_t^D, \quad \tilde{\varepsilon}_t^P\right] \tag{12}$$

where all tildes represent values that have been normalized to lie between 0 and 1, using the normalization constants in Table 1. Both decisions utilize information about the reserve fund balance and debt, but $u^{\mathcal{D}}$ uses last year's balance plus accumulated interest, while $u^{\mathcal{W}}$ uses the updated value from the present year (Figure 2). Both decisions also use the current power price index. Finally, the cash flow prior to withdrawal/deposit, x_t^{C2}, is used for $u^{\mathcal{W}}$ but not $u^{\mathcal{D}}$. Because the M RBFs are shared across the two decisions, $L = \max(L^W, L^H) = 4$.

The outer functions ϕ^W and ϕ^H (Equation 9) each consist of multiple nested functions performing specific operations. The more straightforward ϕ^H consists of a normalization function, ϕ^{HN}, and a constraint function, ϕ^{HC}. Let z_t be the argument to ϕ^H, the action prescribed by the constant shift and sum of radial basis functions in Equation 9 when H is substituted for $\mathcal{D}$. This equation can be decomposed as

$$u_t^H = \phi^H(z_t) = \phi^{HC}\left(\phi^{HN}(z_t)\right) \tag{13}$$

ϕ^{HN} scales the hedging contract slope to the proper scale, $[0, k^H]$ ($M/inch), where k^H is the hedging contract normalization constant in Table 1.

$$z_t' = \phi^{HN}(z_t) = k^H \max(\min(z_t, 1), 0) \tag{14}$$

ϕ^{HC} constrains the contract slope to be greater than or equal to a constant threshold, $k^H d^H$, where the threshold parameter $d^H \in [0, 1]$ is included in the policy parameter vector to be optimized, along with a^H, $\mathbf{w}^H$, $\mathbf{c}$, and $\mathbf{b}$.

$$u_t^H = \phi^{HC}(z_t') = \begin{cases} z_t', & \text{if } z_t' \geq k^H d^H \\ 0, & \text{otherwise} \end{cases} \tag{15}$$

The outer function for the withdrawal decision, ϕ^W, consists of four nested operations. Let z_t now be the sum of the constant shift and RBFs in Equation 9 when W is substituted for $\mathcal{D}$. Then:

$$u_t^W = \phi^W(z_t) = \phi^{WCO}\left(\phi^{WCI}\left(\phi^{WW}\left(\phi^{WN}(z_t)\right)\right)\right) \tag{16}$$

where ϕ^{WCO}, ϕ^{WCI}, ϕ^{WW}, and ϕ^{WN} are the outer constraint, inner constraint, withdrawal transformation, and normalization functions. First, when designing the withdrawal policy, it was discovered that the EMODPS search produces better results when z_t is defined as the prescribed post-withdrawal cash flow rather than the withdrawal itself. For this reason, the normalization function, ϕ^{WN}, transforms z_t to the scale of $[-k^R, k^R]$ ($M), where k^R is the normalization constant for all revenues and cash flows in Table 1.

$$z_t' = \phi^{WN}(z_t) = k^R \max(\min(2z_t - 1, 1), -1) \tag{17}$$

The withdrawal transformation function, ϕ^{WN}, transforms z_t' from a cash flow into a withdrawal/deposit using the relationship between incoming and outgoing cash flow:

$$z_t'' = \phi^{WW}(z_t') = z_t' - x_t^{C2} \tag{18}$$

The inner constraint function, ϕ^{WCI}, ensures that the withdrawal/deposit is consistent with cash-balance equations:

$$z_t''' = \phi^{WCI}(z_t'') = \begin{cases} \min\left(z_t'', \quad r^F x_{t-1}^F\right), & \text{if } z_t'' >= 0 \\ \max\left(z_t'', \quad -max\left(x_t^{C2}, 0\right)\right), & \text{otherwise} \end{cases} \tag{19}$$

The first condition ensures that a withdrawal ($z_t'' > 0$) cannot be larger than the balance in the reserve fund. The second case dictates that a deposit ($z_t'' < 0$) is only allowed when the available cash flow x_t^{C2} is positive, and that the deposit cannot be larger in magnitude than this cash flow.

Lastly, the outer constraint, ϕ^{WCO}, ensures that the reserve fund balance (after withdrawal/deposit) cannot be larger than a constant threshold, $k^F d^W$, where k^F ($M) is the normalization constant used for the reserve fund and debt in Table 1, and $d^W \in [0,1]$ is another decision variable to be optimized.

$$u_t^W = \phi^{WCO}(z_t''') = \begin{cases} r^F x_{t-1}^F - k^F d^W, & \text{if } \left(r^F x_{t-1}^F - z_t'''\right) > k^F d^W \\ z_t''', & \text{otherwise} \end{cases} \tag{20}$$

This threshold sets the maximum allowable reserve fund size, equivalent to x_{max}^F in the static formulation.

Equations 8-20 constitute the full dynamic control policy. The parameter vector to be optimized for each decision $\mathcal{D} \in \{W, H\}$ is

$$\boldsymbol{\theta}_{dyn}^{\mathcal{D}} = [a^{\mathcal{D}}, \quad d^{\mathcal{D}}, \quad \mathbf{w}^{\mathcal{D}}, \quad \mathbf{c}, \quad \mathbf{b}] \tag{21}$$

where $\mathbf{w}^{\mathcal{D}} = \left[w_0^{\mathcal{D}}, ..., w_M^{\mathcal{D}}\right]$, $\mathbf{c} = [c_{0,0}, ..., c_{L,M}]$, and $\mathbf{b} = [b_{0,0}, ..., b_{L,M}]$. The total parameter vector to be optimized, $\boldsymbol{\theta}_{dyn}$, is the set of unique parameters,

$$\boldsymbol{\theta}_{dyn} = [a^W, \quad a^H, \quad d^W, \quad d^H, \quad \mathbf{w}^W, \quad \mathbf{w}^H, \quad \mathbf{c}, \quad \mathbf{b}] \tag{22}$$

3.2 Objective formulations

This study uses "noisy" objective formulations to account for the uncertainty of outcomes under the stochastic drivers. Each candidate policy is assessed using a Monte Carlo (MC) ensemble of N realizations, each representing one possible trajectory of the hydro-financial system under a T-year sample of the stochastic drivers. To convert an ensemble of time series into a scalar objective thus requires both a time aggregation step (e.g., the maximum of debt over a T-year realization) and a noise filtering step (e.g., the 95th percentile over N realizations in the ensemble). Four objectives are considered.

First is the expected annualized cash flow, J^{cash}, a measure of "average" cash flows. A high value represents a low-cost risk management policy, so J^{cash} should be maximized.

$$J^{cash}\left(x^{C4}_{t\in(1,\ldots,T)}, x^F_T, x^D_T\right) = E_{\boldsymbol{\varepsilon}}\left[ANN_t\left(x^{C4}_{t\in(1,\ldots,T)}, x^F_T, x^D_T\right)\right] \tag{23}$$

where x^{C4}_t is the final cash flow for year t; x^F_T and x^D_T are the reserve fund balance and debt at the end of the simulation; $E_{\boldsymbol{\varepsilon}}$ is the expectation over the stochastic drivers (approximated by the mean of N MC samples); and ANN_t is the annualization operator:

$$ANN_t\left(x^{C4}_{t\in(1,\ldots,T)}, x^F_T, x^D_T\right) = \frac{1}{\sum_{t=1}^{T}(r^A)^t}\left(\sum_{t=1}^{T}\left((r^A)^t x^{C4}_t\right) + (r^A)^{T+1}\left(r^F x^F_T - r^D x^D_T\right)\right) \tag{24}$$

where where r^A is the real discount rate and r^F and r^D are the real interest rates on reserves and debt (Table 1). ANN_t sums the net present value (NPV) of all discounted cash flows over T years, plus the NPV of the reserve fund and debt in year T, and divides this sum by a normalization factor. The normalized value represents the constant cash flow, or annuity, that is equivalent in terms of NPV to the variable cash flow. On the whole, annualization allows for a fair comparison, accounting for the time value of money, between cash flow time series resulting from different management strategies.

The second objective, J^{debt}, is the 95th percentile of maximum debt. This is a measure of the short-term debt load that would be needed to meet fixed costs in an extremely bad year (or sequence of years). This is used as a proxy for "risk", and a DM would want to minimize this quantity in order to avoid compromising the utility's credit rating, increasing future borrowing costs, and/or risking bankruptcy.

$$J^{debt}\left(x^D_{t\in(1,\ldots,T)}\right) = Q95_{\boldsymbol{\varepsilon}}\left[\max_{t\in(1,\ldots,T)}\left[x^D_t\right]\right] \tag{25}$$

where the max operator takes the maximum debt over a T-year realization, and the $Q95$ operator takes the 95th percentile over the MC ensemble.

The third objective, J^{hedge}, is the expected hedging frequency, to be minimized.

$$J^{hedge}\left(u^H_{t\in(0,\ldots,T-1)}\right) = E_{\boldsymbol{\varepsilon}}\left[\max_{t\in(0,\ldots,T-1)}\left[\mathbf{1}_{u^H_t>0}\right]\right] \tag{26}$$

where the indicator function $\mathbf{1}_{u^H_t>0}$ returns a 1 if the hedging contract slope is non-zero, and a 0 otherwise. J^{hedge} represents the likelihood that the utility will enter into at least one hedging contract over the course of 20 years. Note that each hedging contract does have an annual cost, a "loading" applied by the contract seller that makes the expected payout of h (SI Figure S2) negative (Hamilton et al., 2020). However, this cost is already accounted for by J^{cash}, and does not need to be double-counted. J^{hedge}, rather, relates to the significant extra costs (in time, personnel, and/or money) of having to set up the first hedging contract within a realization, assuming that this start-up cost will be significantly diminished in subsequent contract purchases.

The last objective is the expected maximum reserve fund balance, J^{fund}:

$$J^{fund}\left(x^F_{t\in(1,\ldots,T)}\right) = E_{\boldsymbol{\varepsilon}}\left[\max_{t\in(1,\ldots,T)}\left[x^F_t\right]\right] \tag{27}$$

This objective represents the expected value of the largest reserve fund used in a T-year realization, and should be minimized. This objective would be important if a utility is worried that rate-payers or regulators would be critical of large liquid reserves.

Finally, a "debt sustainability" constraint ensures that feasible policies do not allow debt to grow unchecked over time (on average), which would likely lead to a credit downgrade in practice:

$$E_{\boldsymbol{\varepsilon}}\left[x^D_T - x^D_{T-1}\right] < \epsilon \tag{28}$$

where ϵ is a small constant (Table 1). This "noisy" constraint is calculated from the entire MC ensemble; there is no constraint on debt use in individual extreme realizations.

3.3 Multi-objective evolutionary optimization of control policies

As described in Sections 1 and 3.1.2, DPS has a number of advantages relative to traditional methods such as SDP, especially when combined with non-linear approximating networks such as RBFs. However, RBF parameterization can result in a highly non-linear and non-convex search space that is difficult to traverse with gradient-based methods, especially when combined with noisy multi-objective formulations (Giuliani & Castelletti, 2016; Giuliani, Mason, et al., 2014; Giuliani et al., 2018). These problems are better handled by MOEAs, which use evolution-inspired strategies (e.g., selection, mating, mutation) to iteratively improve a population of solutions competing on multiple objectives (Coello Coello, Lamont, & Van Veldhuizen, 2007). Population-based methods can approximate the entire Pareto set in a single run, rather than rerunning many single-objective optimizations, making them quite efficient on many-objective problems. Additionally, these heuristic approaches require no information on the topology of a problem and are well-adapted to the types of nonlinear, non-convex, high-dimensional, and stochastic problems that are common in both water resources (Maier et al., 2014; Nicklow et al., 2010; Reed, Hadka, Herman, Kasprzyk, & Kollat, 2013) and finance (Ponsich et al., 2013; Tapia & Coello Coello, 2007).

This study employs the Borg Multiobjective Evolutionary Algorithm (MOEA) (Hadka & Reed, 2013), which has been particularly successful across a range of difficult problems in water resources (Gupta et al., 2020; Hadka & Reed, 2012; Reed et al., 2013; Zatarain Salazar, Reed, Herman, Giuliani, & Castelletti, 2016) and engineering design (Singh et al., 2020; Woodruff, Reed, & Simpson, 2013). The Borg MOEA includes novel components such as adaptive search operator selection, adaptive population sizing, stagnation detection via epsilon-progress, and epsilon-dominance archiving. Its self-adaptive nature makes the Borg MOEA highly controllable (Hadka & Reed, 2013; Reed et al., 2013), and the master-worker parallel variant used in this study is scalable on high-performance computing infrastructure (Giuliani et al., 2018; Zatarain Salazar et al., 2017).

3.4 Information theoretic sensitivity analysis

A sensitivity analysis (SA) is an evaluation of the effects of a model's input factors on its output factors, and a wide range of methods are available to suit different purposes. According to the taxonomy of SA introduced by Pianosi et al. (2016), the method that follows would be considered a quantitative, global, "all-at-a-time" SA, based on simulation model output. This SA is used to explore how different policies adapt their actions to changing conditions; more specifically, it will probe the sensitivity of the prescribed hedging and withdrawal decisions (Equation 8) to changing informational inputs (Equations 11-12). This type of analysis can help to "open the black box" of control policies, helping DMs better understand how different policies respond to changing information (Quinn et al., 2019).

However, commonly-used variance-based methods, which decompose the variance of an output variable into contributions from covariance with different input variables, are inappropriate in the proposed context. First, the policies described by Equations 9-20 are highly non-linear and discontinuous, so that variance and covariance are inappropriate measures of variability and relationship. Secondly, most variance decomposition methods assume independence between the input variables, and can lead to misleading results when this independence is violated (Borgonovo, 2007; Borgonovo, Castaings, & Tarantola, 2011). This is especially problematic in the current context because most Pareto-optimal solutions will impose the following relationship between the reserve fund and debt: if one is large, the other is usually zero. For these reasons, moment-independent global SA methods, such as entropy-based SA (Auder & Iooss, 2009; Krzykacz-Hausmann, 2001), are preferred. Hejazi, Cai, and Ruddell (2008) use ITSA to study the impact of hydrologic information on historical release decisions made by reservoir operators under different conditions. A similar approach is adopted here to study how different policies along the Pareto front use model state information to make decisions.

Shannon entropy (Shannon, 1948) quantifies how much information is needed, on average, to describe a random variable. Consider $u^{\mathcal{D}}$, $\mathcal{D} \in \{W, H\}$, the two policy-prescribed actions. $u^{\mathcal{D}}$ is a function of the information vector, $\boldsymbol{\mathcal{I}}^{\mathcal{D}}$, which varies stochastically through time and across MC realizations. As such, both the information vector and the prescribed action can be considered random variables, $\mathbf{I}^{D}$ and $U^{\mathcal{D}}$. The entropy of the action is:

$$H(U^{\mathcal{D}}) = -\sum_{u^{\mathcal{D}} \in \upsilon^{\mathcal{D}}} p(u^{\mathcal{D}}) \log_2 p(u^{\mathcal{D}}) \tag{29}$$

where $p(u^{\mathcal{D}})$ is the probability mass function (PMF) after discretizing the outcome to a discrete domain, $\upsilon^{\mathcal{D}}$. The entropy (in bits when written with a base-2 logarithm) can be thought of as a moment-free measure of uncertainty, or dispersion, in the probability distribution of a random variable. A variable whose outcome is known deterministically has zero entropy, while a uniformly distributed variable is the most uncertain and has the largest possible entropy. Although a continuous variant of entropy based on Kullback-Leibler divergence can also be used for SA (Auder & Iooss, 2009; Liu, Chen, & Sudjianto, 2006; Pappenberger, Beven, Ratto, & Matgen, 2008), the discrete version is more straightforward when the random variable's distribution is unknown.

The mutual information between two random variables measures the average reduction in the entropy of one variable when the other variable's outcome is known:

$$MI(\mathbf{I}_i^{\mathcal{D}}, U^{\mathcal{D}}) = H(U^{\mathcal{D}}) - H(U^{\mathcal{D}}|\mathbf{I}_i^{\mathcal{D}}) \tag{30}$$

$$= -\sum_{\boldsymbol{\mathcal{I}}_i^{\mathcal{D}} \in \boldsymbol{\iota}_i^{\mathcal{D}}} \sum_{u^{\mathcal{D}} \in \upsilon^{D}} p(\boldsymbol{\mathcal{I}}_i^{\mathcal{D}}, u^{\mathcal{D}}) \log_2 \frac{p(\boldsymbol{\mathcal{I}}_i^{\mathcal{D}}, u^{\mathcal{D}})}{p(\boldsymbol{\mathcal{I}}_i^{\mathcal{D}}) p(u^{\mathcal{D}})} \tag{31}$$

where $\mathbf{I}_i^{\mathcal{D}}$ is the random variable for the ith informational input (e.g., reserve fund balance or power price index), $H(U^{\mathcal{D}}|\mathbf{I}_i^{\mathcal{D}})$ is the entropy of the action conditional on the input, $p(\boldsymbol{\mathcal{I}}_i^{\mathcal{D}})$ is the PMF for the input on the discrete domain $\boldsymbol{\iota}_i^{\mathcal{D}}$, and $p(\boldsymbol{\mathcal{I}}_i^{\mathcal{D}}, u^{\mathcal{D}})$ is the joint PMF on the discrete domain $\boldsymbol{\iota}_i^{\mathcal{D}} \times \upsilon^{\mathcal{D}}$. This mutual information is a measure how much information the outcome of one random variable contains about the outcome of the other: how much does knowledge of a particular informational input reduce the uncertainty in the prescribed action?

Finally, the ITSA index is defined by dividing the mutual information by the entropy of the prescribed action:

$$\eta_i^{\mathcal{D}} = \frac{MI(\mathbf{I}_i^{\mathcal{D}}, U^{\mathcal{D}})}{H(U^{\mathcal{D}})} \tag{32}$$

where $\eta_i^{\mathcal{D}}$ is the sensitivity index for the ith input for decision $\mathcal{D}$. This index varies between 0 and 1; $\eta_i^{\mathcal{D}} = 0$ implies that $\mathbf{I}_i^{\mathcal{D}}$ and $u^{\mathcal{D}}$ are independent random variables, while $\eta_i^{\mathcal{D}} = 1$ implies perfect dependence (knowledge of $\mathbf{I}_i^{\mathcal{D}}$ gives us perfect knowledge of $u^{\mathcal{D}}$).

4 Computational experiments

4.1 Problem formulations

This study considers both the static and dynamic control formulations, each of which has its own parameter vector to be optimized. The static parameter vector ($\boldsymbol{\theta}_{stat}$, Equation 7) has two elements to be optimized. The dynamic parameter vector, ($\boldsymbol{\theta}_{dyn}$, Equation 22) has $4+2M+2ML$ elements, where $L=4$ is the number of informational inputs, and M is the number of RBFs in the policy. With $M = 2$ RBFs (see next section), $\boldsymbol{\theta}_{dyn}$ contains 24 elements to be optimized.

For each control formulation, both two-objective and four-objective problems are considered. The two-objective problem can be written:

$$\boldsymbol{\theta}^* = \arg\min_{\boldsymbol{\theta}} \left[-J^{cash}(\boldsymbol{\theta}), \quad J^{debt}(\boldsymbol{\theta})\right] \tag{33}$$

while the four-objective problem can be written:

$$\boldsymbol{\theta}^* = \arg\min_{\boldsymbol{\theta}} \left[-J^{cash}(\boldsymbol{\theta}), \quad J^{debt}(\boldsymbol{\theta}), \quad J^{hedge}(\boldsymbol{\theta}), \quad J^{fund}(\boldsymbol{\theta})\right] \tag{34}$$

For both problems, the feasible solution space is restricted to solutions satisfying the sustainable debt constraint (Equation 28). The two-objective problem is the same as that used by Hamilton et al. (2020), allowing for a direct comparison, while the four-objective problem provides more nuanced insight into risk management tradeoffs.

4.2 MOEA parameters

An ensemble of $N = 50,000$ realizations is run for each function evaluation, balancing computational demand against the need to minimize sampling error in the noisy objective/constraint evaluations (see discussions in Kasprzyk et al. (2012); Quinn, Reed, Giuliani, and Castelletti (2017); Zatarain Salazar et al. (2017)). In order to select the appropriate number of RBFs, the dynamic 4-objective formulation is repeated with 1, 2, 3, 4, 8, and 12 RBFs. Due to the inherent stochasticity of evolutionary algorithms, each optimization is repeated with 10 different random seeds. Each seed is run for 150,000 function evaluations (candidate policy trials). Final populations are assessed in terms of hypervolume, additive epsilon indicator, and generational distance (SI Figure S3), three common metrics for assessing convergence, consistency, and diversity of multi-objective solution sets (Coello Coello et al., 2007; Hadka & Reed, 2012; Reed et al., 2013). Results are found to be relatively insensitive to the number of RBFs used in the dynamic control policies, but $M = 2$ RBFs is chosen due to their robust performance across seeds. Next, 20 additional seeds are run for the dynamic 4-objective formulation with $M = 2$, and 30 seeds each are also run for the dynamic 2-objective, static 2-objective, and static 4-objective formulations. The best known Pareto approximate set for each formulation is the set of non-dominated solutions from across the 30 seeds. After using the same 50,000-member ensemble of 20-year simulations for all formulations/seeds in the initial optimization, each solution in the final Pareto approximate set for each formulation is rerun on a separate 50,000-member ensemble, for which results are reported. Important parameter values for the optimization can be found in SI Table S1; all other Borg MOEA parameters besides those listed are set to the default values (Hadka & Reed, 2013; Reed et al., 2013).

4.3 Information theoretic sensitivity analysis parameters

ITSA indices for each specific operating policy are calculated using a 50,000-member ensemble of 20-year simulations, yielding 1,000,000 realizations of $\mathcal{I}_i^{\mathcal{D}}$ and $u^{\mathcal{D}}$. Each component is discretized into 50 bins in order to calculate the marginal and joint probability mass functions (Equations 29, 31). This process is repeated for each control policy in the Pareto set, yielding separate ITSA indices for each.

5 Results and discussion

5.1 Static vs. dynamic financial risk management

Figure 3 shows the resulting Pareto approximate sets from the 2-objective optimization problem (Equation 33), under both static and dynamic control formulations. Each point represents a different financial risk management policy. The ideal performance, denoted by a black star, would be achieved with a cash flow objective (J^{cash}) of \$10.99M (the average net revenue in the absence of any financial risk management) and a debt objective (J^{debt}) of zero. However, this is not possible due to the strong tradeoff between "risk" and "return" that is standard in financial risk applications: in order to achieve higher expected cash flows, the utility must forego costly risk management actions and therefore risk more extreme debt burdens in less favorable realizations. As discussed in Section 3.2, large short-term debt in our model can be viewed as a proxy for larger financial disruptions such as credit rating downgrades or bankruptcy in practice. DMs will have to balance this tradeoff when selecting a particular policy for the utility to use, based on risk aversion, access to credit, and other organizational factors.

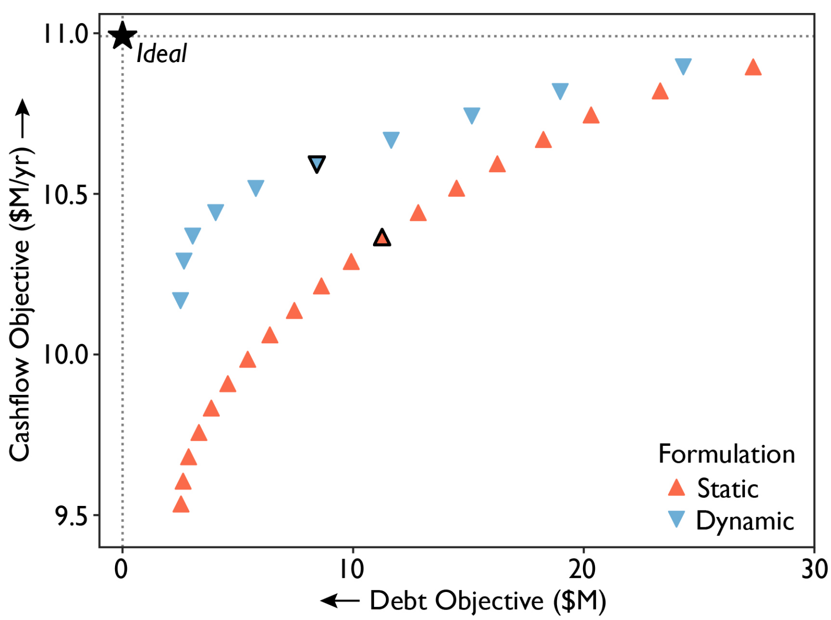

Figure 3. Comparison of 2-objective Pareto approximate sets under static and dynamic control formulations. The best compromise policy from each formulation is outlined in black and described in Table 2.

However, DMs can drastically reduce the risk management tradeoff by using adaptive operating rules that respond to changing conditions. The Pareto approximate set from the dynamic EMODPS control formulation is found to dominate the Pareto approximate set from the static formulation, suggesting that one can improve on both the cash flow and debt objectives simultaneously. For example, consider the two example policies outlined in black in Figure 3 and listed in rows 1-2 in Table 2. These are chosen as the "best compromise" policies near the centers of their respective Pareto approximate sets (as selected using the TOPSIS method with equal weights on each objective (Behzadian, Khanmohammadi Otaghsara, Yazdani, & Ignatius, 2012; Roszkowska, 2011)). The dynamic policy is found to reduce J^{debt} by \$2.83M, or 25.1%, relative to the static policy. At the same time, it increases J^{cash} by \$0.23M, representing a 36.1% reduction in risk management cost relative to the "ideal" J^{cash} value of \$10.99M. This dual improvement highlights the value of dynamic financial risk management: the utility can improve on both objectives simultaneously without requiring any investment in its infrastructure or changes to its physical operations. All that is required is to switch to a more flexible and efficient financial risk management policy.

Table 2. Six example policies referenced in the results, along with their four-objective performance and their information theoretic sensitivity indices related to the hedging action.

Row	Figure	J^{cash} (\$M/yr)	J^{debt} (\$M)	J^{hedge} (unitless)	J^{fund} (\$M)	Fund Sensitivity	Debt Sensitivity	Power Sensitivity
1	3 red	10.37	11.25	1.00	16.11	–	–	–
2	3 blue	10.59	8.42	1.00	19.31	0.74	0.11	0.12
3	7	10.75	15.90	0.77	12.01	0.36	0.72	0.01
4	8a	10.20	3.22	1.00	24.55	0.93	0.12	0.00
5	8b	10.71	15.72	0.40	16.83	0.44	0.96	0.01
6	8c	9.84	8.96	1.00	1.53	0.02	0.03	0.72

The dynamic formulation allows the utility to take different sequences of actions under different stochastic realizations, using parameterized control rules that allow for the actions taken at any particular time to be better tailored to the current state of the system. To elucidate the differences between static and dynamic financial risk management, the two best compromise policies are simulated under two different 20-year realizations from the synthetic record: an unusually wet period and an unusually dry period (Figure 4). Differences in SWE (4a) lead to drastic differences in hydropower generation (4b) and net revenues (4d) under the two realizations, and the dry scenario experiences lengthy periods of drought-related cash flow deficits. The two scenarios also yield very different responses in terms of the hedging policy (4e & 4i), reserve fund balance (4f & 4j), debt (4g & 4k), and final cash flow (4h & 4l). In the wet scenario, the reserve funds fill up quickly and stay nearly full. Neither policy requires any significant debt, and final cash flows are generally positive and rather large. In the dry scenario, the reserve funds fluctuate up and down, including two periods in which they reach zero. During these periods, significant debt is required to overcome further cash flow deficits. The final cash flows are close to zero throughout the dry simulation, as both policies struggle to fill their reserve funds.

With respect to the hedging contract, the static policy uses the same contract each year in both the wet and dry scenarios, with a payout slope of \$0.32M/inch. The dynamic policy, on the other hand, adjusts its contract slope from year to year. In the wet scenario, it opts not to hedge at all after year 0, while in the dry scenario, it fluctuates between \$0 and \$0.85M/inch. Comparing the hedging slope dynamics to the other model state variables suggests that this policy opts to hedge only when the reserve fund balance is low and/or when debt is non-zero. This strategy allows the dynamic policy to achieve higher cash flows than the static policy in wet scenarios (Sub-Figure 4h), by foregoing the cost of hedging contracts when the utility already has sufficient protection from a large reserve fund. On the other hand, when the reserve is empty and/or there is outstanding debt (presumably after a very dry year or sequence of years), the utility purchases large hedging contracts in order to increase its financial risk coverage and thus reduce the risk of extreme debt levels (Sub-Figure 4k). This adaptivity allows the dynamic policy to improve on both the cash flow objective and the debt objective simultaneously, compared to the static policy. As will be seen in Section 5.3, there are a multiplicity of ways that utilities can adapt to changing conditions to meet their goals.

5.2 Many-objective decision-making

As discussed in Section 3.2, a DM choosing a financial risk management policy may actually consider other factors beyond risk (J^{debt}) and return (J^{cash}). For example, the

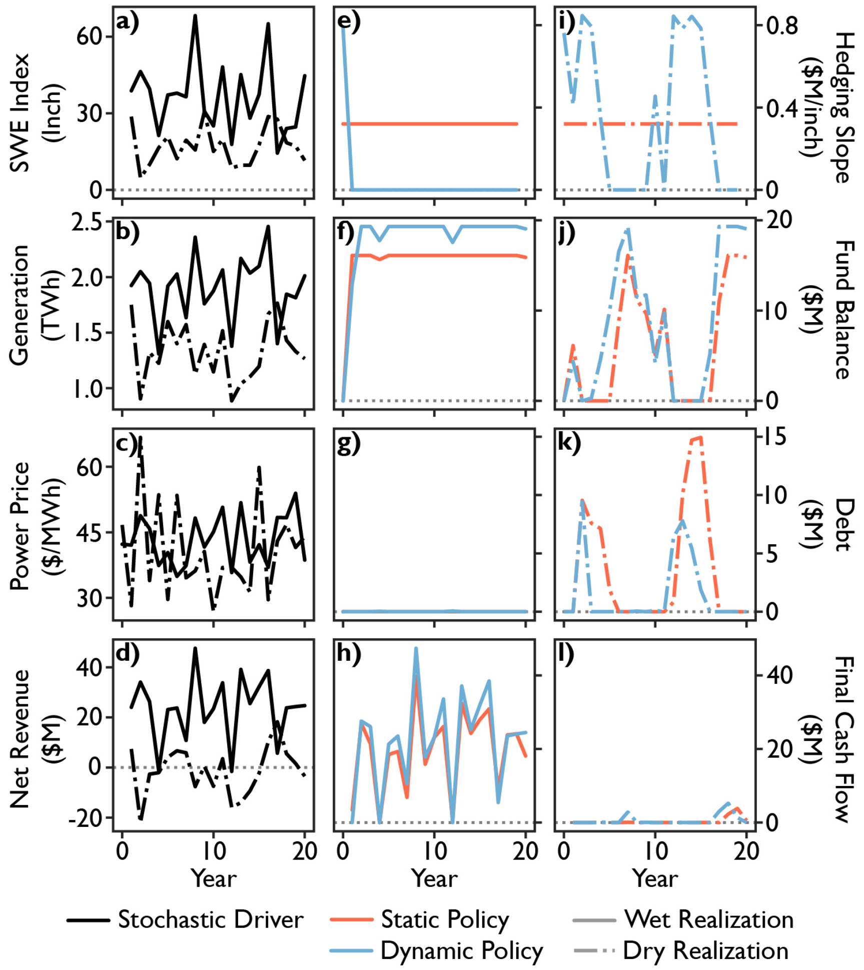

Figure 4. Trajectories for hydro-financial simulation model, over both wet and dry 20-year realizations, for the example static and dynamic policies shown in Figure 3 and rows 1-2 of Table 2. Sub-Figures show the SWE index (a), hydropower generation (b), power price (c), net hydropower revenue (d), hedging slope action (e & i), fund balance (f & j), debt (g & k), and final annual cash flow (h & l). Middle column (e-h) shares its y-axis with the right-hand column (i-l).

utility might also worry about the size of the reserve fund needed to enact a particular policy (J^{fund}), or the likelihood of needing to enact a complicated hedging program (J^{hedge}). Such DMs are likely to find that none of the solutions found under the 2-objective problem (Figure 3) can meet their needs. The 2-objective problem cannot adequately represent the tradeoffs that a utility manager must weigh when making these decisions because it does not account for DM preferences with respect to the use of different risk management tools. For this reason, J^{hedge} and J^{fund} can be explicitly included in the optimization using the 4-objective problem (Equation 34).

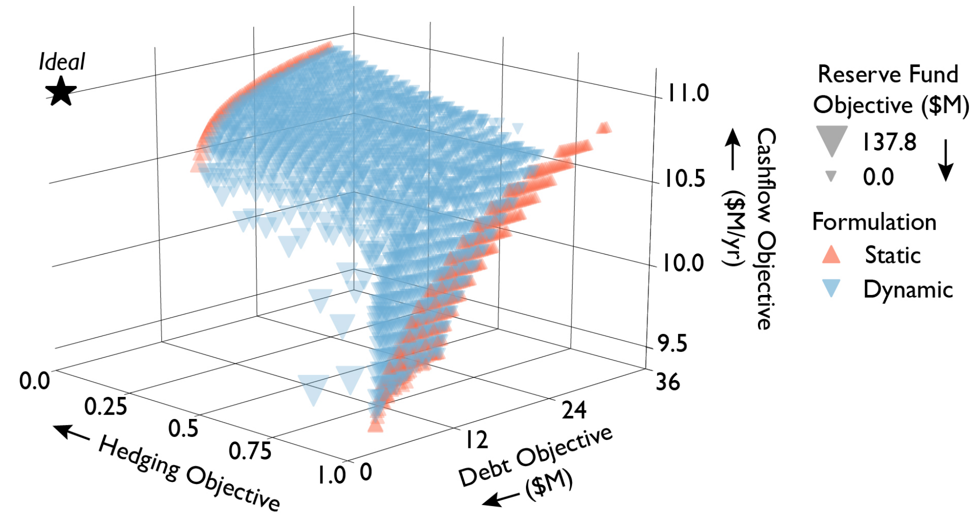

Figure 5. Comparison of 4-objective Pareto approximate sets under static and dynamic control formulations.

Both the static and dynamic formulations produce much larger Pareto approximate sets in this higher-dimensional problem (Figure 5), representing the more complex set of tradeoffs across the four objectives. The dynamic Pareto approximate set is found to generally outperform the static Pareto approximate set, especially in terms of the overall diversity of solutions. For the static formulation, where the hedging contract slope is fixed, J^{hedge} must be equal to 1 or 0. The dynamic formulation, on the other hand, is able to find policies with J^{hedge} spanning the entire range from 0 to 1. Note that J^{hedge} is defined as the fraction of 20-year realizations that contain any hedging, not the fraction of years which hedge (see Equation 26). Thus, intermediate values between 0 and 1 represent solutions that are unlikely to hedge in any given year, but maintain the option to do so under particularly problematic circumstances. This valuable optionality is only possible with a dynamic control strategy. Additionally, the dynamic solution set occupies a much larger region within the ridge where $J^{hedge} = 1$. These policies outperform the nearest static policies with respect to J^{cash} and J^{debt}, but may require the use of larger reserve funds. Because the dynamic control method produces a much more complete and continuous Pareto approximate set, it allows DMs to find control policies that more precisely match their preferences.

A major benefit of solving the larger-dimensional problem is that the solution set will already contain all of the tradeoffs for all possible lower-dimensional problems (di

Pierro, Khu, & Savić, 2007). In the present context, the 4-objective Pareto front will include within it the Pareto fronts for the four 3-objective problems, six 2-objective problems, and four 1-objective problems that are embedded within the 4-objective problem (Figure 6). In Sub-Figure 6a, the blue triangles show the subset of the 4-objective Pareto approximate set that is non-dominated with respect to the original two objectives, J^{cash} and J^{debt}. When compared to the original 2-objective solutions (Figure 3), the 4-objective policies are very similar with respect to the first two objectives. However, they can achieve improvements with respect to the two new objectives (see SI Figure 4). In other words, it is possible to improve J^{fund} and/or J^{hedge} with no penalty in J^{cash} or J^{debt}, but they must be included in the optimization explicitly to realize this benefit.

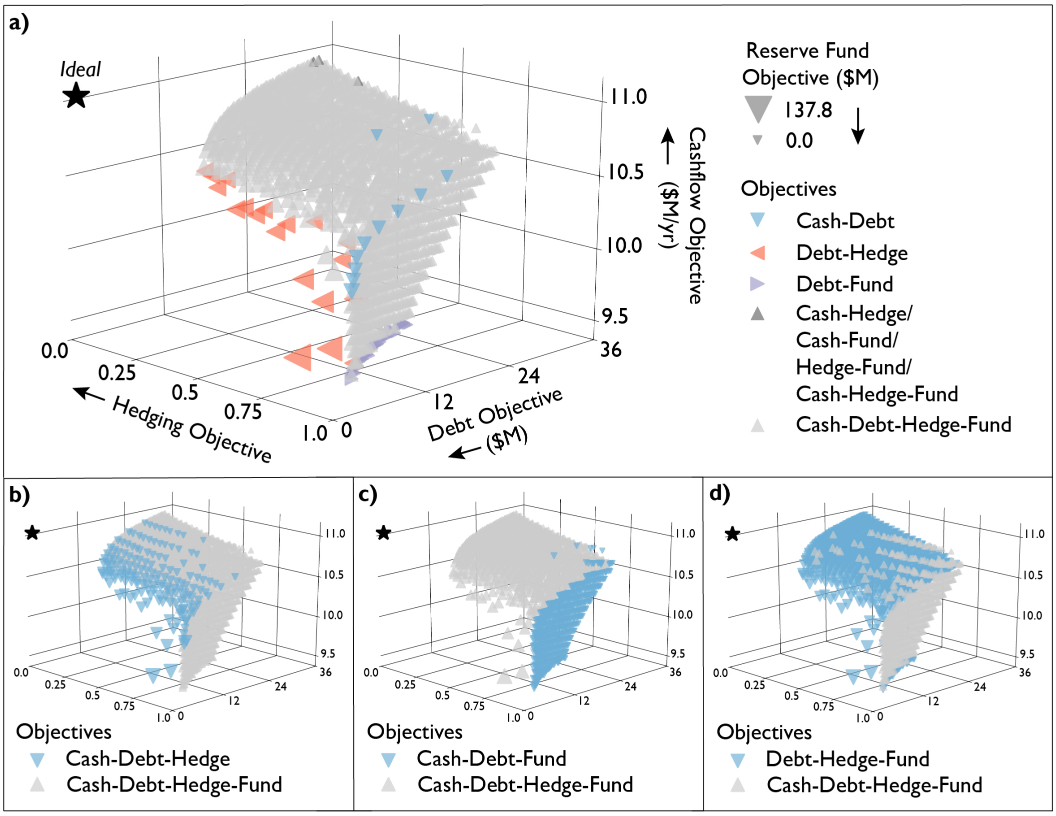

Figure 6. Visualization of Pareto approximate sets for different sub-problems. Colored points represent solutions that are non-dominated with respect to a particular sub-problem; for example, orange points in sub-figure (a) represent solutions that are non-dominated with respect to J^{debt} and J^{hedge}. Light grey points in all sub-figures represent solutions from the 4-objective problem that are not captured in the lower-dimensional problems.

More broadly, the lower-dimensional sub-problems tend to produce Pareto approximate sets that are near the extreme boundaries of the larger-dimensional problem. Sub-Figure 6a includes four sub-problems for which the Pareto approximate set consists of a single solution (J^{cash}-J^{hedge}, J^{cash}-J^{fund}, J^{hedge}-J^{fund}, J^{cash}-J^{hedge}-J^{fund}). Each of these sub-problems excludes debt, leading to a single optimal policy that performs essentially no risk management. This is consistent with prior work finding that conflicts in higher-dimensional problems can remain hidden in lower-dimensional sub-problems (Woodruff et al., 2013). Sub-Figure 6a also shows results for the J^{cash}-J^{debt}, J^{debt}-J^{hedge}, and J^{debt}-J^{fund} sub-problems. Each subset of solutions is concentrated along an outer border of the larger Pareto front, where performance of the two explicitly-considered objectives is optimized at the expense of the other two objectives. The same pattern is evident in the 3-objective sub-problems of Sub-Figures 6b (J^{cash}-J^{debt}-J^{hedge}), 6c (J^{cash}-J^{debt}-J^{fund}), and 6d (J^{debt}-J^{hedge}-J^{fund}). These solution sets are larger, but still occupy extremal regions of the overall Pareto front. Thus, by choosing to optimize a 2- or 3-objective sub-problem, DMs may unwittingly produce an incomplete and biased Pareto approximate set.

The larger-dimensional problem leads to a fuller set of alternatives that better represents the tradeoffs associated with DM preferences for different financial risk management tools. However, it is a non-trivial task to select a single operating policy from among the large Pareto approximate set. Interactive visualization approaches can help with this task. One example is to allow DMs to apply *a posteriori* performance criteria and “brush away” solutions that fail to meet these constraints (Kollat & Reed, 2007; Zeff et al., 2014). The strictness of the constraints can be iteratively increased until DMs are relatively agnostic about the tradeoffs across the feasible solution set. For example, consider a utility whose financial team (perhaps in consultation with its regulatory commission) develops the following criteria: if $\bar{R} = \$10.99$ million is the mean annual net hydropower revenue in the absence of any risk management, then (1) the risk management policy should not reduce expected annualized cash flows by more than 2.5% ($J^{cash} \geq 0.975\bar{R}$); (2) the utility should rarely be forced to borrow more than 150% of mean net revenue to cover cash flow deficits ($J^{debt} \leq 1.5\bar{R}$); and (3) the utility should not maintain reserves larger 150% of mean net revenue ($J^{fund} \leq 1.5\bar{R}$). These constraints drastically reduce the set of feasible solutions (Figure 7). At this point, a quantitative method such as TOPSIS (Behzadian et al., 2012; Roszkowska, 2011) can be used to select one of the remaining policies for the utility to use (e.g., the policy outlined in Figure 7 and listed in row 3 of Table 2).

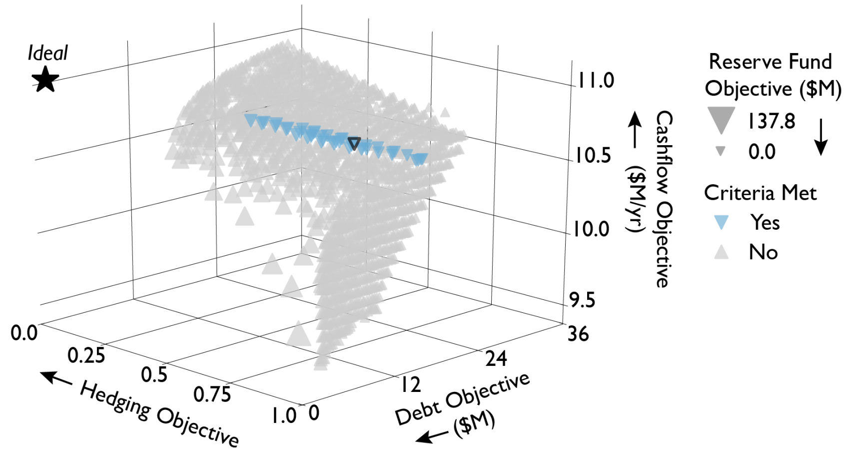

Figure 7. Set of feasible solutions after filtering for stakeholder-determined *a posteriori* constraints. The best compromise policy from the feasible set is outlined in black and described in row 3 of Table 2

While these constraints could, in theory, be applied *a priori* and used to reduce the number of objectives in the optimization, it is very difficult in practice for DMs to effectively set the constraint values without first understanding the topology of the tradeoff surface (Kasprzyk et al., 2016; Spronk et al., 2005). This confirms the value of the EMODPS approach, which is scalable to extremely large problems on modern high-performance computing infrastructure (Giuliani et al., 2018; Zatarain Salazar et al., 2016), suggesting that the formulation used here could be expanded to include additional objectives such as customer rates, social equity, and environmental quality.

5.3 Value of state information for control

As demonstrated above, the EMODPS method can be used to develop control policies that perform well across a range of stakeholder preferences. However, DMs may be unwilling to adopt a complex, non-linear control policy if its operating rules remain opaque; it may be necessary to "open the black box" for users if they are to apply such tools in practice (Castelvecchi, 2016; Quinn et al., 2019). Each policy represents a map from a vector of inputs (e.g., reserve fund balance) to its outputs (e.g., the hedging contract slope). ITSA (Section 3.4) can help DMs to better understand how different policies respond to changing model state information. Figure 8 shows the hedging policy sensitivity indices for each solution in the Pareto approximate set, representing the degree to which each policy adjusts its annual hedging decision based on each of the three inputs: the reserve fund balance (η^H_F, Sub-Figure 8a), the debt (η^H_D, 8b), and the power price index (η^H_P, 8c). Each index is a measure of the importance of a particular input variable for controlling a state-aware policy; $\eta = 1$ implies that the policy is entirely controlled by the input, while $\eta = 0$ means that the input has no impact on the policy. Interestingly, Figure 8 shows that each input has a different "region of specialization" in objective space. The reserve fund balance is the most important input for policies along the top of the ridge where $J^{hedge} = 1$. These are policies that achieve a relatively low levels of debt and high levels of cash flow, in return for frequent hedging and a relatively large reserve fund. The debt information, on the other hand, is critical for policies occupying the swath of objective space with J^{hedge} between 0 and 1. The power price index is less informative, but it does provide value for policies requiring minimal reserve funds and debt, along the bottom edge of the Pareto front.

In order to better understand how these policies utilize the information that is available to them, it is helpful to visualize the policies themselves. To that end, one high-sensitivity policy is chosen for each input (as outlined in Figure 8, and listed in rows 4-6 of Table 2). Each policy is used to simulate 20 random trajectories of length 20 years, for a total of 400 annual decisions. These decisions are visualized in state-action space using parallel-coordinate plots (Figure 9). The first three vertical axes represent the three hedging policy inputs: reserve fund balance, debt, and power price index. The policy output, the hedging contract slope, is represented by the fourth vertical axis as well as the colorbar in order to aid interpretation. Each of the colored lines connecting the four axes represents one of the 400 simulated decisions. These visualizations, in combination with the sensitivity indices, can be useful in understanding how each policy operates. For example, the policy in Sub-Figure 9a appears to hedge selectively, when the reserve fund balance has fallen below a certain threshold. Above the threshold, no hedging contract is purchased, and below the threshold, the hedging slope increases as the fund balance falls. The policy in Sub-Figure 9b has a similar strategy, but structured around debt; hedging is zero below some threshold, and increases with debt above the threshold. Lastly, the bottom policy always utilizes hedging contracts, the magnitude of which tend to be

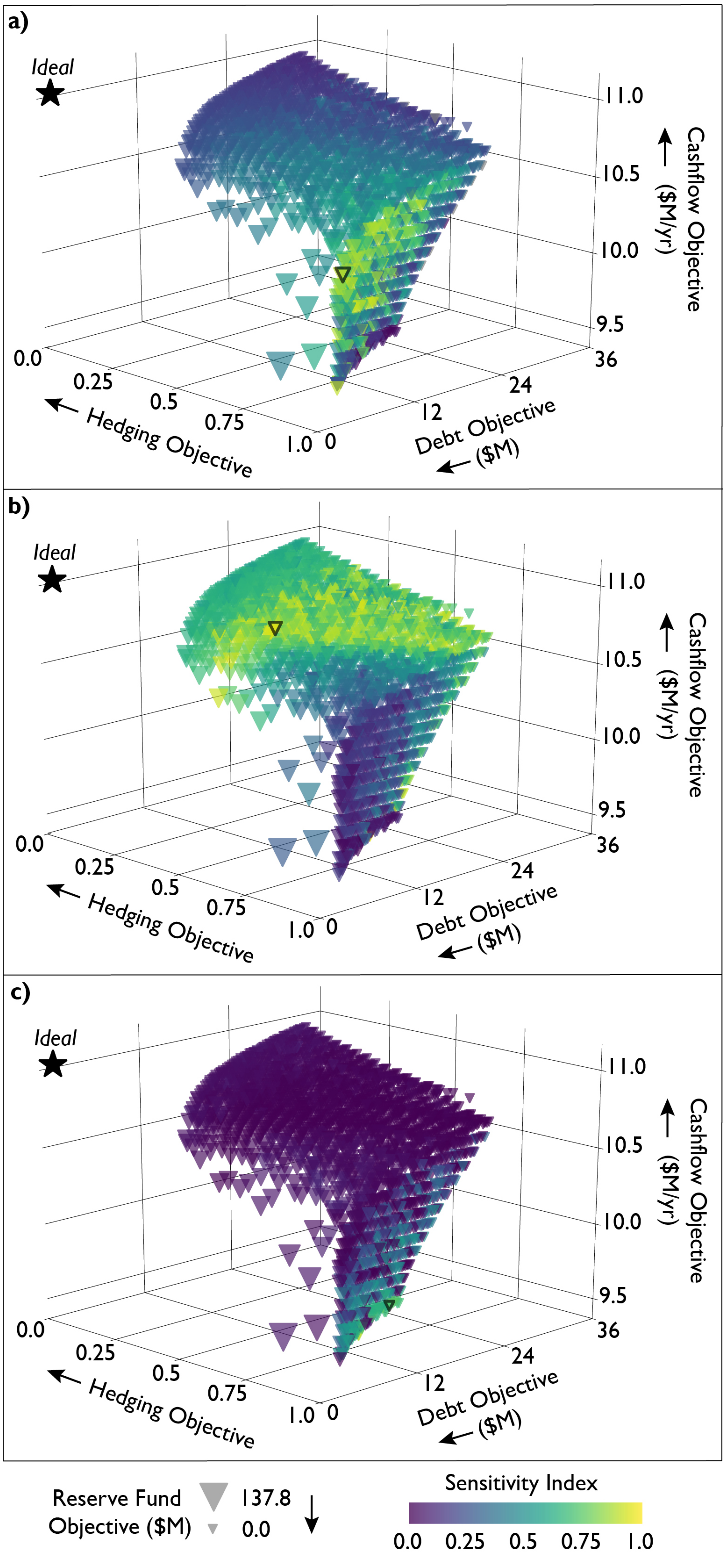

Figure 8. Information theoretic sensitivity indices, relative to hedging contract slope decision, for the reserve fund balance (a), debt (b), and power price index (c). One high-sensitivity solution for each input is outlined in black and described in rows 4-6 of Table 2

inversely proportional to the power price index. Each of these patterns is consistent with the sensitivity indices in Figure 8 and Table 2.

These plots can be used to build intuition about how the different risk management policies achieve their competitive advantages. For example, compare the fund-sensitive policy (a) to the debt-sensitive policy (b). The former maintains a relatively large reserve fund for its risk management needs, and uses hedging contracts as a substitute to maintain its risk protection when the reserve fund is inadequate. This is qualitatively similar behavior to the example policy simulated in Section 5.1 (Figure 4). The debt-sensitive policy, on the other hand, keeps a much smaller reserve fund, which results in more frequent cash flow shortfalls and debt during dry years. In order to reduce the likelihood of extreme debt spirals during longer droughts, this policy begins to use hedging contracts when it has significant debt, and ceases hedging once it has paid off this debt. The result is that the debt-sensitive policy is significantly more risky than the fund-sensitive policy, but in return, it is less costly and requires less frequent hedging and a smaller reserve fund. The power-sensitive policy (c) takes a more consistent approach, purchasing similar hedging contracts each year. This makes it the most expensive contract of the three due to the cost of these contracts. However, the risk coverage from hedging allows it to maintain a very small reserve fund and still avoid substantial debt. This policy does adjust its hedging contract in response to projected wholesale power prices using the power price index. If the index is high, then the utility expects that its net revenue per unit of hydropower will be higher than average, and vice versa when the index is low. By purchasing hedging contracts in inverse proportion to this index, the utility can dampen the overall variability of its combined cash flow (hydropower net revenue plus the net payout from the hedging contract), and thus reduce its financial risk.

ITSA and policy visualization plots for the withdrawal/deposit decision can be found in SI Figures S5-S6. However, withdrawals and deposits are found to be much less sensitive to model state information than hedging, suggesting that the gains from dynamic financial risk management in this study largely accrue from dynamic hedging rather than dynamic reserve fund management. In future problems with a larger number of candidate actions, an iterative scheme for selecting the most sensitive decisions to control dynamically would be beneficial. One final takeaway from Figures 8 and 9 is that the most important model states to include in a state-aware control policy can vary widely across the Pareto approximate set. This implies that the most important input(s) cannot be

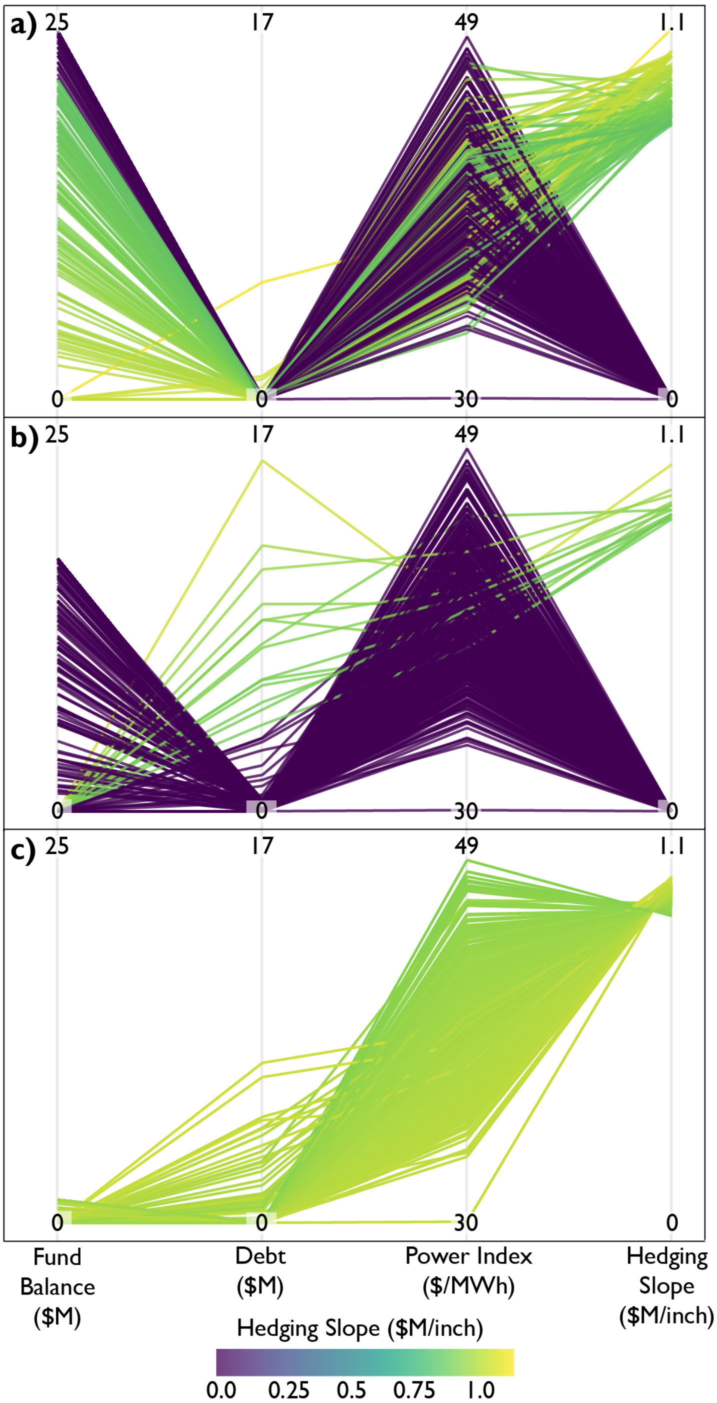

Figure 9. Hedging control policy visualization for three chosen policies in Figure 8 and rows 4-6 of Table 2. Policies (a), (b), and (c) are highly sensitive to the reserve fund, debt, and power price index information, respectively. The first three vertical axes represent the three inputs, while the fourth axis and the colorbar represent the hedging action. Each line connecting the four axes represents one state-action combination experienced within a simulation.

known *a priori* without accounting for DM preferences. This is consistent with both analytical (Graham & Georgakakos, 2010; Tejada-Guibert, Johnson, & Stedinger, 1995) and empirical (Hejazi et al., 2008) studies in the reservoir control literature, which have found that the objective(s) of the operator can affect which hydrologic factors are deemed most informative. However, computational constraints often require that the total set of potentially informative data be culled to a small subset of the most important variables. The results of this study confirm the importance of accounting for the multi-dimensional nature of information value during this process (Denaro et al., 2017; Giuliani et al., 2015).

A limitation of this study is the implicit assumption of stationarity embedded in the hydro-financial simulation model adopted from Hamilton et al. (2020). Despite this fact, Figure 4 suggests that the EMODPS-derived policies trained on a stationary MC ensemble can perform relatively well across a wide range of potential outcomes, many of which are extreme compared to historical data. Additionally, the present study concerns purely financial decisions on relatively short time scales, for which interannual climate variability is expected to overwhelm longer-term non-stationarity (Lehner et al., 2020). The reader is referred to Hamilton et al. (2020) for further discussion of these issues. Nonetheless, future studies should consider a broader analysis of the impacts of changing climate, markets, etc., on the robustness of adaptive financial risk management strategies for hydropower production. This would be especially important if the framework proposed here were to be combined with dynamic infrastructure investments (Haasnoot, Kwakkel, Walker, & ter Maat, 2013; Kwakkel, Haasnoot, & Walker, 2015; Zeff, Herman, Reed, & Characklis, 2016). For large, irreversible decisions such as infrastructure development, medium- to long-term uncertainties become increasingly important (Doss-Gollin, Farnham, Steinschneider, & Lall, 2019). Future work should focus on integrating additional sources of information regarding climate, power markets, etc. Statistical learning approaches can be used to update decision-making based on evolving beliefs about the non-stationary hydro-financial system (Fletcher, Lickley, & Strzepek, 2019; Fletcher et al., 2017; Herman, Quinn, Steinschneider, Giuliani, & Fletcher, 2020). Additionally, scenario discovery approaches can be used to search for financial risk management strategies that perform satisfactorily across a wide range of (perhaps deeply) uncertain factors (Bryant & Lempert, 2010; Herman, Reed, Zeff, & Characklis, 2015; Kasprzyk, Nataraj, Reed, & Lempert, 2013; Lempert, 2002; Quinn, Hadjimichael, Reed, & Steinschneider, 2020).

6 Conclusions

A substantial body of literature has emerged around optimal control of water reservoir systems in the face of hydrologic uncertainty (Macian-Sorribes & Pulido-Velazquez, 2019). Evolutionary multi-objective direct policy search (EMODPS) has emerged as an especially powerful tool for overcoming the simultaneous curses of dimensionality, modeling, and multiple objectives that are characteristic of problems in the field (Giuliani et al., 2016, 2018). This paper demonstrates that the same properties of EMODPS that make it ideal for optimal reservoir control problems also make it well suited for the complex, multi-objective financial risk management problems faced by water-reliant organizations as a result of hydrologic variability. The methodology is applied in the context of the hydrologic financial risk faced by the Power Enterprise of the San Francisco Public Utilities Commission (SFPUC), an electricity producer relying primarily on hydropower from a snow-dominated watershed. EMODPS is used to develop control policies that dynamically balance financial hedging, cash reserves, and debt, based on changing conditions within the model. Performance is quantified based on four conflicting objectives: expected annualized cash flow, 95th percentile maximum debt, expected hedging frequency, and expected maximum reserve fund balance. The first two objectives represent the classic return vs. risk tradeoff in finance, while the second two objectives represent a decision-maker's preferences for using one risk management instrument over another based on an organization's individual circumstances. By utilizing real-time model state information when making decisions, the dynamic policies produced by EMODPS are found to significantly outperform policies produced under a more static control formulation akin to those commonly used for financial risk management in the water resources literature. *A posteriori* visual analytics and information theoretic sensitivity analysis can be used to help decision-makers better understand how the complex, non-linear operating policies adapt to real-time information when making decisions. The methodology developed in this paper should help stakeholders to better understand the dynamic relationships between hydrology, decision-making, and financial outcomes, and facilitate more knowledgeable and effective management of hydrologic financial risks. This work is applicable to other electric utilities that rely on hydropower, as well as other stakeholders for whom environmental variability poses a significant financial risk, such as water utilities, agricultural producers, and renewable energy developers.

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