Articles

Can Producers Place Valid and Reliable Valuations on Wool Price-Risk Information?

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Using the contingent valuation method farmers in the high rainfall region of Western Australia were asked to value the information that they used to reduce risk associated with wool prices. To ascertain whether these values were both valid and reliable they were combined with additional data collected from the questionnaires and incorporated into profit functions so that farmers' attitudes towards risk could be estimated. These risk attitudes may be deemed reliable and valid providing they correspond to those estimated by other researchers. Results showed that the farmers' risk aversion coefficients were comparable to those estimated in the Australian literature. Therefore it may be argued that these farmers were able to nominate valid and reliable valuations for the information that they used.

1. Introduction

Traditionally the contingent valuation method (CVM) has been used to value consumer goods (Mitchell and Carson; Wilks; Adamowicz). However, if the supply of non-market production inputs, for example those used in agriculture, is to be continued, suppliers of these inputs need to understand their value in order to make efficient allocation decisions. To ascertain the suitability of the CVM to valuing a production input, information designed to reduce wool price-risk and provided to farmers in the high rainfall region of Western Australia was selected as the focus of this study. Such information is provided to farmers by both private and public sources.

To ensure the credibility of the results, survey data should also be assessed for its reliability and validity. Several suggestions may be found in the CVM literature as to testing reliability and validity (Kealy, Dovidio and Rockel; Mitchell and Carson; Reiling, Boyle, Phillips and Anderson; Imber, Stevenson and Wilks). One such test which is appropriate for determining reliability associated with the value farmers placed on wool price-risk information involves conducting econometric analyses. By finding a respectable adjusted squared multiple correlation coefficient Pluske argued that the values farmers placed on this information were reliable. To further argue for the reliability and validity of farmers' values for wool price-risk information, Asafu-Adjaye's initiative of testing for validity and reliability by determining if the values obtained from a CVM survey agree with predictions from economic theory will be developed in this paper.

Data including the value, or more specifically the maximum value (MV) farmers placed on wool price-risk information was collected in a survey designed to reduce as many potential biases as possible. Farmers decided upon a MV subject to the monetary benefits they believed they gained from a reduction in wool price-risk. These responses were then incorporated into a model so that unknown production characteristics such as farmers' attitudes towards risk could be estimated. The reasoning behind this procedure was based on work completed by Fraser which showed that farmers' attitudes towards risk could be estimated from survey data concerning willingness-to-pay for crop insurance collected by Patrick. In addition it was noted from Freebairn and Babcock that agricultural information is of value to farmers if its use increases farmers' levels of utility. This increase may be achieved by farmers using information that causes risk associated with wool price to be reduced. There-

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fore by placing relevant data concerning this risk reduction into a production model, the estimated risk aversion coefficients could be compared to those estimated, for similar farmers, using other methods such as outlined by Bond and Wonder and Bardsley and Harris. This comparison will provide the CVM researcher with some knowledge as to the reliability and validity of the MVs farmers placed on wool price-risk information.

In the remainder of this paper the methodology developed to estimate the risk aversion coefficients of farmers, given their nominated MVs for information and expected level of farm revenue is explained. Then the methodology is applied using data collected from farmers by Pluske. Results are presented and discussed and conclusions are drawn at the end of the paper.

2. Methodology

In this study it is assumed that farmers know the prices for all their inputs, therefore the only uncertain price parameter is the output price (ie., wool price) and is referred to in what follows as price-risk. In addition, wool yield per hectare was assumed to be known with certainty. This assumption was based on empirical data regarding the variability of wool production. Harris, Crawford, Gruen and Honan estimated that output variability was responsible for less than six per cent of wool income variation, while Piggott (1987) estimated the production coefficient of variation of fine combing wool (20-24 microns) to be only 3.7 per cent.

If it is further assumed that wool price uncertainty is multiplicative, then revenue before the use of wool price-risk information may be given by:

(1) $\Psi = \phi\, w\, L\, \Phi$

where:

Ψ = revenue generated from on-farm operations

ϕ = random variable representing wool price uncertainty ($E(\phi) = 1$)

w = wool yield per hectare

L = hectares of land allocated to wool

Φ = expected price received per unit of wool

Since $E(\phi) = 1$, expected revenue can be given by:

(2) $E(\Psi) = w\, L\, \Phi$

Profit can be expressed as:

(3) $\pi = \Psi - P_i\, x - F$

where:

π = profit

x = quantity of inputs

P_i = vector of input prices

F = whole farm fixed costs

So that expected profit may be represented by:

(4) $E(\pi) = E(\Psi) - P_i\, x - F$

Given the assumption of certain input prices, variance of profit can be expressed as:

$Var(\pi) = Var(\Psi)$

(5) $= (w\, L\, \Phi)^2\ Var(\phi)$

Information aimed at reducing price-risk can then be added into the model. The consequence of this addition is to create an opposite effect to that of mean preserving spread. As Sandmo explained[1], the effect of reducing variance in a model can be achieved by replacing price with $[1/(1+i_1)\,(p - \Phi) + \Phi]$ where for the purpose of this study i_1 is the quantity of information required to reduce price-risk. Therefore when information aimed at reducing price-risk is obtained, revenue can be written as:

(6) $(\Psi_{i1}) = 1/(1+i_1)\,[\Psi - E(\Psi)] + E(\Psi)$

(where $0 \leq i_1$)

and so $E(\Psi)$ is unchanged from Equation 2 above because $\Psi = E(\Psi)$.

Profit may be represented by:

(7) $(\pi_{i1}) = 1/(1+i_1)\,[\Psi - E(\Psi)] + E(\Psi) - P_i\, x - P_{i1}\, i_1 - F$

(where: P_{i1} = MV of information)

[1] Hey extends upon this theory.

so that $E(\pi)$ is smaller than that of Equation 4 by the MV for information which has been added as an additional cost.

Variance of profit may be depicted by:

$$(8) \quad Var(\pi_{i1}) = [(w\ L\ \Phi) / (1+i_1)]^2\ Var(\phi)$$

which is less than or equal to the $Var(\pi)$ shown in Equation 5 above as $0 \leq i_1$. That is, $Var(\pi)$ has decreased but so also has $E(\pi)$ by the MV that a farmer has nominated for the information.

The MV for information aimed at reducing variance of wool prices depends not only on farmers' expected revenue and profit, derived from wool production, but also on their expected increase in utility resulting from use of the information which, in turn, depends upon their attitude towards risk. As illustrated by Anderson, Dillon and Hardaker, with a reduction in the mean and variance utility may increase. Therefore expected utility of profit may be written as:

$$(9) \quad E[U(\pi)] = U[E(\pi)] + \tfrac{1}{2}\, U''\ [E(\pi)]\ Var(\pi)$$

which indicates that expected utility can be approximately expressed as a function of mean and variance of profit (Newbery and Stiglitz). Although an approximation, mean-variance analysis has been widely used in theoretical and empirical studies of microeconomic decision making because of its analytical tractability.

The constant relative risk aversion function may be expressed as;

$$(10) \quad U(\pi) = \pi^{(1-R)}/(1-R)$$

where; R is the risk aversion coefficient

and $U''\ [(\pi)] = -R\ (\pi)^{-R-1}$ *or* $-R\ (\pi)^{-(R+1)}$

Farmers' utility functions were estimated using the constant relative risk aversion function which is supported by Pope and Just for use in agricultural research. In finding the risk attitudes of Australian farmers, Bardsley and Harris estimated the partial risk aversion coefficient. However, for an expected utility model expressed in terms of profit (as in this study) instead of wealth, Pope and Just stated that relative and partial risk aversion are identical and therefore the results derived from this study can be compared to those estimated by Bardsley and Harris.

Therefore substituting this functional form into equation (9) gives;

$$(11) \quad E\ [U(\pi)] = E(\pi)^{(1-R)}/(1-R) + \tfrac{1}{2}\ (-R\ E(\pi)^{-(1+R)})\ Var\ (\pi)$$

By using this equation, an approximation of the expected utility, with and without information to reduce price-risk, may be derived. The difference between these two values may be converted into a certainty equivalent of profit which should approximate MV. Alternatively, as indicated by Anderson *et al*, if a reduction in expected profit occurs, for risk averse people (ie., the numerical measure of their attitude towards risk is above zero) to retain the same utility, variance associated with this expected profit must be reduced. Therefore given MV, the risk aversion coefficient (R) required to equate the expected utility before the use of information (Equation 9), with expected utility after information is used (ie., with MV paid for a reduction in price risk; Equation 11) can be estimated.

In so doing a number of steps had to be taken. First, initial revenue and profit were estimated from information provided by farmers who completed the questionnaire. Second, to calculate profit after the use of risk reducing information, the MV farmers placed on price-risk information was assumed to be also the cost of this information and so was deducted from the initial profit amount.

Third, the initial price-risk and the decrease in this risk resulting from the use of information had to be calculated by assumption. This step was required because it was considered too difficult a task for farmers to provide this data. However, as assumptions had to be made in this context a sensitivity analyses was conducted using various values for the original coefficient of variation of wool price (CV_p). In addition assumptions as to the extent of reduction in this CV_p resulting from the use of information were also varied.

Given the data available from the farmer surveys and that derived from the assumptions made, an estimate for the value of R could thus be determined. As stated above this can be achieved by varying R until the value of expected utility before and after use of risk reducing information is equated.

To elaborate upon these important steps in the model the following numerical example has been devised from fabricated data. Mr Farmer achieves an ex-

pected wool revenue of $100,000 and an expected profit of $50,000. The CV_p is assumed to be 20 per cent. Mr Farmer may acquire information that will reduce this CV_p by 25 per cent to 15 per cent. He decides that his MV for this risk reduction is $500. Incorporating this data into the model discussed above, Mr Farmer's risk aversion coefficient may be found by altering R until his expected utility before and after use of the risk reducing information is the same. This step is accomplished with a value for Mr Farmer's risk aversion coefficient (R) of 0.259 indicating that he is risk averse.

3. Application

The two Australian studies most relevant to compare with the results from this project are those completed by Bardsley and Harris (this research showed that farmers in the high rainfall region of Australia had a mean partial risk aversion coefficient of 0.1 while those in the sheep/wheat zone had a coefficient of 0.7) and Bond and Wonder. It was concluded from both studies that farmers operating in a high rainfall zone were slightly risk averse given the small risk aversion coefficients. Therefore it was hypothesised that this project would show that farmers operating in the high rainfall region of Western Australia would be risk averse and that their average risk aversion coefficient would be small.

Murrell estimated the underlying coefficient of variation of price for 21 micron wool to be 23.34 per cent and for 23 micron wool to be 12.38 per cent. Farmers in the high rainfall region specified in this study produced wool at around 21 micron (I.H. Williams, pers. comm.).[2] Therefore for this study the coefficient of variation of wool price (CV_p) was assumed to be 20 per cent. However, sensitivity analyses with the CV_p at 17, 18, 22 and 23 per cent were also undertaken.

Murrell found that the impact of the RPS for wool was a general reduction in the CV_p. She estimated that for 21 micron wool the CV_p was reduced from 23.34 per cent to 10.28 per cent, which is a 56 per cent reduction in CV_p. As the farmer survey used to collect MVs for information to reduce price-risks was conducted after the removal of the RPS, a difficulty in this study was estimating the decrease in CV_p derived from farmers using this information because they were not asked to estimate the decrease in CV_p from the information that they utilised. Since Newbery and Stiglitz found that most individuals are not proficient at estimating probabilities, it was decided that farmers could have problems estimating the decrease in the CV_p achieved from using information and this could have jeopardised other survey results. Instead it was assumed that the decrease in CV_p for all farmers obtaining wool price-risk information was one half of that estimated by Murrell as achieved by the RPS. That is, a reduction of 28 per cent. This scenario will be referred to as the base-case scenario. The CV_p was also decreased by one quarter (14 per cent), three eighths, or 21 per cent, five eighths, or 35 per cent and three quarters (42 per cent) in sensitivity analyses. These sensitivity analyses are important to determine if the farmers' mean risk aversion coefficient estimated using parameters from the base-case scenario is robust.

The survey used to collect farmers' MVs for information to reduce price-risk also contained questions to find out demographic information about farmers. These included wool production figures which were placed in an optimal farm plan, so that expected revenue and profit could be estimated for each farmer.[3] It was assumed that the cost of acquiring this information for the farmer was negligible and so it was not included in the calculations.

4. Results

In the base-case scenario, the risk aversion coefficient (R) for each farmer nominating a MV for agricultural information to reduce price-risk was calculated when the coefficient of variation for wool price (CV_p) was decreased by 28 per cent from an original value of 0.2. This base-case reduction resulted in a mean R value (R') of 0.28 (Table 1) indicating that farmers were slightly risk averse. In a series of sensitivity analyses the CV_p was reduced by 14 per cent to give a R' of 0.47 and by 21 per cent resulting in a R' of 0.35 (Table 1). When the CV_p was reduced by 35 per cent, R' was found to be 0.23 and with a decrease of 42 per cent, the R' fell to 0.20 (Table 1). To test whether the R' found in each of the sensitivity analysis was significantly different from the R' determined for the base-case reduction, independent samples T-tests were

[2] I.H. Williams is a Senior Lecturer, Department of Animal Science, The University of Western Australia.

[3] Anderson *et al* explain an optimal farm plan on pages 224-225. The optimal farm plan relevant to this study was developed by John Young (using MIDAS), Department of Agriculture, Western Australia.

conducted. For reductions in the CV_p of 14, 21, 35 and 42 per cent the hypothesis that the R' values would not be significantly different to that found for a reduction of 28 per cent was accepted only for the scenarios with a decrease in the CV_p of 21 and 35 per cent (p0.05) (Table 1).

Table 1:

The Mean Risk Aversion Coefficients (R') for Farmers When the Base-case CV_p of 0.2 was decreased by 28 per cent and 14, 21, 35 and 42 per cent in Sensitivity Analyses with the Statistical T-test Values Shown in Brackets

Decrease in CV_p (%)	R'
28 (Base-case)	0.28
14	0.47[a] (-3.16)
21	0.35 (-1.44)
35	0.23 (1.20)
42	0.20[a] (2.03)

[a] denotes values that are significantly different to the base-case of R'=0.28 (p).

To gain a better understanding of the range of R values for the individual farmers, four groups were identified (Table 2). These groupings were constructed from individual profit functions. For a reduction of 28 per cent in the CV_p, none of the farmers had a R value greater than one, two per cent had a R value of between 1 and 0.7, 38 per cent of farmers had a R of between 0.7 and 0.3 and the remaining 60 per cent had a R less than 0.3 (Table 2). When the CV_p was reduced by 21 per cent, two per cent of the farmers had a R value greater than one, with 13 per cent having a R value between 1 and 0.7, 36 per cent of the farmers possessing a R value between 0.7 and 0.3, and the remaining 49 per cent having a R value less than 0.3 (Table 2). Reducing the CV_p by 35 per cent showed that none of the farmers surveyed had a R value above 0.7, 29 percent experienced a R value between 0.7 and 0.3, and the remaining 71 per cent had a R value less than 0.3 (Table 2).

Sensitivity analyses concerning a change in the base-case CV_p were also conducted. In these analyses the initial CV_p was increased from 0.2 to 0.22 and 0.23 while it was also decreased to 0.18 and 0.17 (Table 3). Reducing each of these new CV_p by 28 per cent as was done for the base-case analysis, resulted in the R' for the former analysis being 0.23 and 0.20 respectively while for the latter analysis the R' was 0.35 and 0.38 respectively (Table 3). These results may be compared to the base-case CV_p of 0.2 being reduced by the same 28 per cent giving a R' of 0.28 (Tables 1 and 3). However, only the analysis whereby the CV_p was reduced by 0.23 could the hypothesis that there was not a significant difference between the R' for each of the sensitivity analyses and the base-case analysis be rejected (p0.05) (Table 3).

Table 2:

The Mean Risk Aversion Coefficients (R') and the percentage of Farmers Falling into Each of the Four Groups when the CV_p was Reduced by 28 per cent and 21 and 35 per cent in Sensitivity Analyses

Group	R'(ΔCV_p=28%[a])	{%}[b]	R'(ΔCV_p=21%[a])	{%}[b]	R'(ΔCV_p=21%[a])	{%}[b]
R>1.0	N/A	{0}	1.04	{2}	N/A	{0}
1.0>R>0.7	0.83	{2}	0.81	{13}	N/A	{0}
0.7>R>0.3	0.48	{38}	0.44	{36}	0.46	{29}
0.3>R>0.0	0.14	{60}	0.14	{49}	0.14	{71}

[a] signifies a reduction by that value in CV_p ie., 28, 21 and 35% reduction in CV_p
[b] the percentage of individual risk aversion coefficients falling into each group.

Table 3:

The Mean Risk Aversion Coefficients (R') for Farmers When the Original CV_p of 0.20, 0.22, 0.23, 0.18 and 0.17 were Decreased by 28 per cent in Sensitivity Analyses with the Statistical T-test Values Shown in Brackets

CV_p	R'
0.20 (Base-case)	0.28
0.23	0.20[a] (1.99)
0.22	0.23 (1.37)
0.18	0.35 (-1.31)
0.17	0.38 (-1.80)

[a] denotes values that are significantly different to the base-case of R'=0.28 (p).

The R values were, as previously, divided into four groups: R>1; 1>R>0.7; 0.7>R>0.3; 0.3>R>0 (Table 2 and Table 4) when the CV_p was reduced by 28 per cent. Reducing a CV_p of 0.22 by 28 per cent resulted in none of the farmers having a R value greater than 0.7, with 29 per cent experiencing a R value between 0.3 and 0.7 and the remaining 71 per cent having a R value below 0.3 (Table 4). Changing the initial CV_p to 0.18 and then reducing it by 28 per cent resulted in two per cent of farmers having an R value greater than one, with 13 per cent having an R value between one and 0.7, 36 per cent having a R between 0.3 and 0.7 and the remaining 49 per cent having a R value below 0.3 (Table 4). A reduction in a CV_p of 0.17 by the same percentage did not change the percentage of farmers falling into each group from the previous analysis.

5. Discussion and Conclusion

In this paper traditional producer methodology has been adapted to include the value farmers place on information to reduce risk associated with wool prices. The results showed that the risk attitude of farmers can be estimated on the basis of their MV for information to reduce risk associated with wool prices, the decrease in variance of wool price and their expected wool revenue.

Table 4:

The Mean Risk Aversion Coefficients (R') and the Percentage of Farmers Falling into Each of the Four Groups When the CV_p was Reduced by 14 and 28 per cent from the Original CV_p of 0.22, 0.18 and 0.17 in Sensitivity Analyses

Original Cv_p	Group	R'(ΔCV_p=28%[a])	{%}[b]
0.22	R>1.0	N/A	{0}
	1.0>R>0.7	N/A	{0}
	0.7>R>0.3	0.45	{29}
	0.3>R>0.0	0.14	{71}
0.18	R>1.0	1.02	{2}
	1.0>R>0.7	0.79	{13}
	0.7>R>0.3	0.43	{36}
	0.3>R>0.0	0.14	{49}
0.18	R>1.0	1.08	{2}
	1.0>R>0.7	0.85	{13}
	0.7>R>0.3	0.46	{36}
	0.3>R>0.0	0.15	{49}

[a] Signifies a reduction by that value in CV_p ie., a 28% reduction in CV_p.
[b] The percentage of individual risk aversion coefficients falling into each group.

Given the assumptions for the base-case scenario including the coefficient of variation for wool price (CV_p) of 0.2 being reduced by 28 per cent, the analysis estimated that farmers were risk averse, with a mean risk aversion coefficient (R') of just under 0.3. Due to the difficulty of calculating the reduction in the CV_p achieved from the use of wool price-risk information various sensitivity analyses were conducted. Of the assumptions made in this paper reducing the CV_p over a range from 14 to 42 percent in sensitivity analyses showed that the mean risk aversion coefficients of farmers changed little over a range from 0.2 to a value just below 0.5. Moreover, only the extreme values of this range were statistically significantly different from the base-case R' of 0.28. Sensitivity analyses of the assumed initial level of the CV_p of 0.2 were also conducted. Varying the CV_p from 0.17 to 0.23 resulted in the R' varying slightly from around 0.4 to 0.2. Once again from a statistical perspective, only increasing the CV_p to 0.23 gave R values which were statistically significantly different to those when the CV_p was 0.2.

In the analyses errors may have arisen in the calculation of the farmers' risk aversion coefficients due to experimental error in collecting the data for the model, from the mispecification of the production function, wrongly assuming the source of risk to be multiplicative or from incorrectly specifying not only the extent of risk reduction from the use of information, but also the uniformity of this reduction among farmers. Nevertheless the results found in this study strongly support the argument that farmers generally express some degree of risk aversion with over half of the farmers having a risk aversion coefficient under 0.3 with a mean value of 0.14. This finding compares to those of Bardsley and Harris and Bond and Wonder. Furthermore the level of risk aversion of most of the surveyed farmers is between that estimated by Bardsley and Harris for farmers in the sheep/wheat zone (ie., 0.7) and that estimated for those in the high rainfall zone (ie., 0.1). Therefore it may be concluded that the results support the argument that the valuations for wool price-risk information given by farmers participating in this CVM survey were valid and reliable estimates of their actual valuations of this information.

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