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## An Economic Model for Bioprospecting Contracts

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## **An Economic Model for Bioprospecting Contracts**

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# **An Economic Model for Bioprospecting Contracts**

## **Summary**

This paper explores the use of a micro-economic model to analyse the provisions and parties of bioprospecting contracts. It focuses on the pharmaceutical industry as the representative biodiversity buyer, presenting an original theoretical framework that explains the main contract characteristics or stylised facts. Against this background, it considers the main contractors involved in these private contracts, i.e. biodiversity sellers and biodiversity buyers, analysing both the magnitude and distribution of the respective payoffs. Particular attention is devoted to the different, mixed impacts of bioprospecting contracts and patenting on social welfare. The positive welfare impacts delivered by bioprospecting contracts are associated with the potential discovery of a new drug product, i.e. productivity gains, non-monetary benefit-sharing or transfers and royalty revenues. The negative welfare impact results from the legal creation of a monopoly and the related well-known effect on the consumer surplus. Finally, the potential redistribution effects are limited, and a potential enforcement of this objective may jeopardise the desirability of the contracts since this action would lead to a significant increase in the transaction costs.

**Keywords:** Bioprospecting Contract, Genetic Resource, Biodiversity Buyer, Biodiversity Seller, Patenting, Welfare Analysis, Benefit Sharing

**JEL Classification:** D21, D23, D61, L14, Q57

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## 1. Introduction

The Convention on Biological Diversity (CBD), launched after the Earth Summit in Rio de Janeiro in 1992, clarified and recognised the sovereign property rights of each country over their own biodiversity resources. The CBD has stated the important legal principle: each country has sovereign property rights over the biodiversity within its jurisdiction, and is able to obtain truthful information about the use of genetic resources, to control the access procedures and to equitably negotiate the benefit-sharing items with the biodiversity prospectors.

By attempting to rule out open access to bioprospecting<sup>1</sup>, the CBD (1992) has established an important legal and economic principle: biodiversity conservation has a (market and non market) value. Therefore, biodiversity value can be negotiated with and embodied into some kind of governance structures.

Within the framework of this new institutional context, the result has been a remarkable increase in the number of bio-prospecting contracts between the Biodiversity Buyers (BB), notably linked to the pharmaceutical industry (e.g. Glaxo), and Biodiversity Sellers (BS), mainly local research institutes operating in geographical areas where a broad range of biodiversity is present (e.g. INBio in Costa Rica). In addition, the number of international institutions (e.g. ICBG) involved in sample-screening activities has been observed to increase (Bhat 1999; Ten Kate and Laird 1999; Dedeurwaerdere 2005).

Starting from this background, the present paper contains an economic analysis of bioprospecting contracts. In particular, we adopt an inductive method that aims at a careful reading and understanding of a selection of existing bioprospecting contracts. We then adopt standard microeconomic analysis in order to define the contractors' objective functions. This is preliminary to deriving original insights that help to capture and understand the main motivations of the

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<sup>1</sup> For the purposes of the study at issue, bioprospecting is defined as the set of activities aiming at collecting, sampling and screening genetic resources, including plants, animals, micro-organisms, as well as sharing indigenous knowledge with significant potential to develop new market products.

stakeholders involved in the bioprospecting negotiation. We focus on explaining the “why” of bioprospecting contracts and parties by scrutinising the provisions of selected bioprospecting contracts in order to understand the way parties organise their transactions.

This is important because “*understanding how and why economic agents use contracts to coordinate their activities is crucial to understanding the organization and efficiency of economic exchange*” (Masten and Saussier, 2002, p. 273)

The paper is organised as follows. Section 2 provides insights into the pharmaceutical industry characteristics and bioprospecting activities. Section 3 contains a review of a number of existing contracts worldwide in order to identify their main provisions and parties, and to interpret the contracts from the perspective of transaction costs theory. Section 4 presents an original theoretical framework that explains the observed and reviewed stylised facts so as to study the different steering forces involved in the two parties’ objective functions. Section 5 includes a welfare analysis of the bioprospecting contracts and patenting. Section 6 concludes.

## **2. Pharmaceutical Research and Bioprospecting Contracts: Some Background Information**

Despite alternative definitions and clarifications available in the literature<sup>2</sup>, in this article the pharmaceutical research process will be defined in terms of a set of discrete steps including: (1) field collection of genetic resources, (2) drug discovery, and (3) drug development – see Figure 1. It is important to note that the last step of pharmaceutical research, with regard to drug development, is the internal research and development (R&D) activity carried out by the pharmaceutical companies. The inputs of the R&D process, in the form of screened samples, are normally

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<sup>2</sup> For example, according to Kate and Laird, pharmaceutical research refers to the “process of discovering, developing, and bringing to market new ethical drug products” (ten Kate and Laird, 1999, pp. 49).

purchased from another party involved in the first two steps, i.e. field collection of genetic resources and drug discovery.

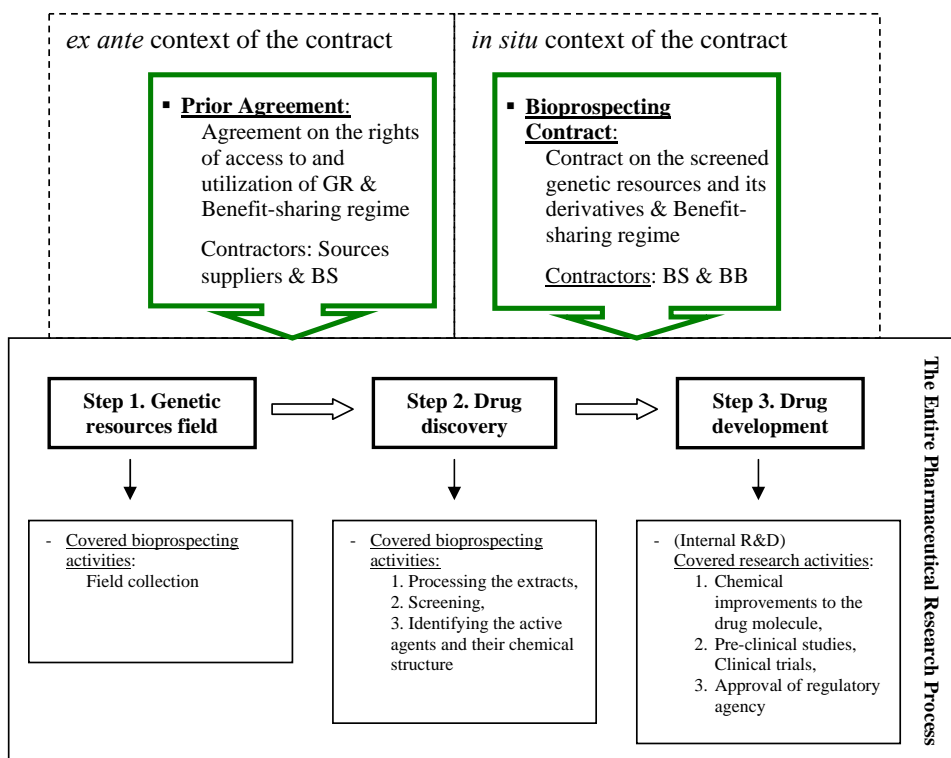


Figure 1 Pharmaceutical research and bioprospecting contract

To distinguish these two parties, we name them biodiversity buyer (BB) and biodiversity seller (BS), respectively. In this context, bioprospecting contracts play an important role in bringing together the BB and BS in a legal negotiation framework, so as to complete the entire pharmaceutical research process. The following sub-sections will discuss these three steps and the associated bioprospecting activities, and will explore the role of bioprospecting contracts.

**2.1. Field collection of genetic resources**

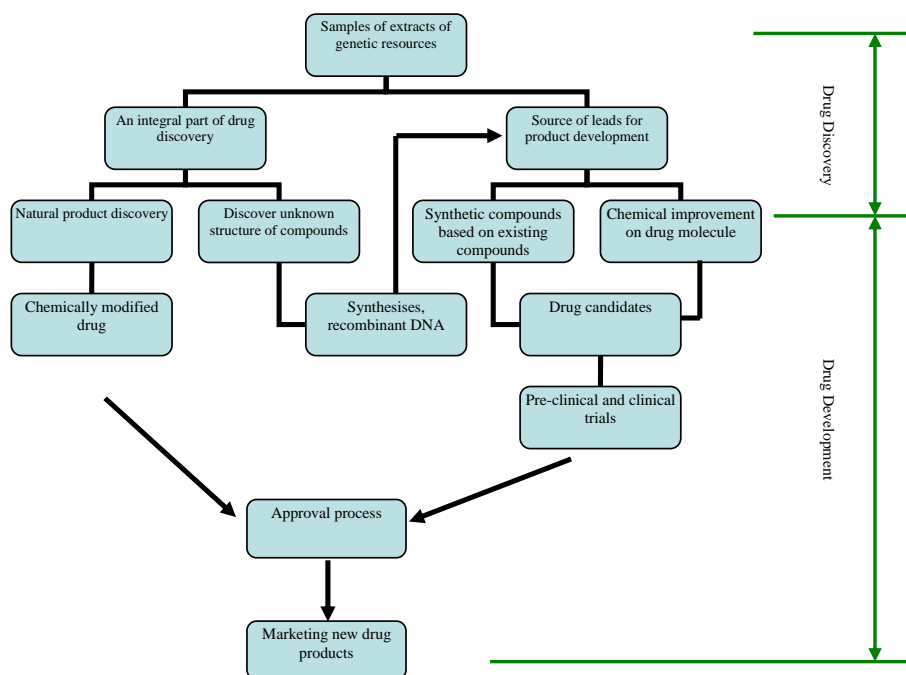
The general conditions for the collection of genetic resources are negotiated between source suppliers<sup>3</sup> and BS. This agreement explicitly clarifies a set of mutually agreed upon terms: (a) the access to and the use of genetic resources in the source country, which is subject to the Prior Informed Consent (PIC) and benefit-sharing treaty, and (b) the restricted manner in which field collection and follow-up research will be conducted. The outcome of the field collection will be further elaborated by the BS, who are granted exclusive access to the genetic resource, while patent rights cover their discoveries in the area under consideration. In many cases, BS refer to local research institutes or universities. This geographical affinity contributes to the establishment of a firm or of a close relationship with the national or local government in the source country. As a matter of fact, these same institutions are often involved in bioprospecting contract negotiations with international pharmaceutical industries, on behalf of the source country. As we can see in Figure 2, genetic resources have an important role in the discovery of new natural drugs or in serving as a source of leads for synthesising new compound structures or products (Ten Kate and Laird 2000; Onaga 2001).

In addition to the local BS mentioned above, in Table 1 we can identify major international institutes that have been involved in biocontracting as biodiversity sellers. In this context international BS contribute to generating additional funding for bioprospecting projects and to supplying technical assistance in capacity-building to the source suppliers. Moreover, as far as benefit-sharing rules are concerned, the transfer of technology from the BS to the source suppliers contributes to strengthening the research ability and efficiency of the source-based institutes. In effect, we can observe a potential increase in the added-value of genetic resources. Furthermore, another important characteristic is that many international research organisations (such as ICBG)

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<sup>3</sup> *Source suppliers* refer to the stakeholders located in source countries that originally have property rights over genetic resources and/or indigenous knowledge. They are important suppliers of raw genetic materials for BS to achieve drug discovery process. However, their cooperating relationship is usually established by a number of informal agreements or authorisation procedures rather than a legal contract, as in most cases BS are national research institutions located in the source countries. For this reason they receive financial support from the local government to conduct the fundamental research related to biodiversity. This condition will be further illustrated in section 4 by means of a review of bioprospecting contracts.

carry out several research programs in different countries. For this reason, the research results and database generated in all collaborative countries will be shared within the involved institutes. As a consequence, the sharing of systematic information on processing genetic resources can contribute to reducing the financial costs of field collection assumed by companies and institutes. In other words, it will be possible to provide higher quality samples or synthetic compounds, or obtain the same sample processing results with a lower field collection effort, and thus reduce the pressure of habitat loss and species extinction. (ICBG 1997; Rausser and Small 2000).



*Figure 2 The contribution of natural products to pharmaceutical research*

Source: Ten Kate and Laird 1999 (adapted).

In conclusion it is important to highlight that all the negotiations involving genetic source suppliers and BS are informal agreements and do not represent the core of bioprospecting contracts. For more information about the involved procedures, see Nunes et al. (2006).



## 2.2. Drug discovery

Drug discovery refers to the set of fundamental research activities carried out by the BS, including the processing of extracts and the screening of samples. The expected output of these activities is the identification of active compounds and their chemical structure, exploring their potential value in pharmaceutical products. As shown in Figure 2, the novel compounds derived from the collected samples can directly contribute to a new natural drug on the market. However, most of the collected genetic materials will serve as a source of leads for drug development (see Section 2.3), and will be closely related to the success in drug R&D. For example, high quality samples are helpful for discovering valuable research leads, which will increase the efficiency of innovation activities (i.e. increase the probability of generating a successful market product with R&D). In addition, research leads derived from high quality samples can provide adequate taxonomical, geographical, and ecological information, and can consequently increase the productivity of discoveries, reduce the need of new field collection, and ultimately result in a decrease in searching costs. Therefore, it is not difficult to conclude that for a pharmaceutical company (i.e. BB), it is not necessary to carry out drug discovery research by itself, but it does matter to select a good collaborator (i.e. BS), who is able to do the best job in sample extracting and screening. Generally speaking, the criteria taken into account by companies include *inter alia* the ability of the biodiversity sellers in providing biologically and chemically diverse samples, the simplicity and legislation of the process to obtain samples, and the prices of the samples (see *Ten Kate and Laird 2000* for more details). The cooperation relationship can be established within a legal framework (i.e. bioprospecting contract) upon a number of commonly agreed items, including the exchanged commodities (i.e. processed genetic resources) and the benefit-sharing regimes, covering both monetary and non-monetary benefits – see Table 1.

In a formal bioprospecting contract, we can observe a direct monetary payment transferred from the pharmaceutical companies to biodiversity sellers (or sample suppliers) in the form of sample

fees<sup>4</sup>, advanced payments, milestone payments and the royalties (see Ten Kate and Laird 1999, for more details). In this case, it is important to note that the price of genetic resources increases when the collected material is subject to additional screening and processing activities performed by the biodiversity seller. In short, biodiversity sellers can be responsible for the creation of market added-value to the originally extracted genetic resources. In addition, an advanced payment is undertaken for compensating the general operational cost of the research institutes. A milestone payment is required when new discoveries are made in the research and development (R&D) phase. In many cases, a royalty is also calculated based on the net sales for commercialised products. Obviously, the amount of milestone and royalty payments depends upon the success in R&D.

In addition, the non-monetary payment (e.g. technology transfer and capacity-building) incurred by pharmaceutical companies is widely recognised to be far more important than the financial benefits from bioprospecting activities obtained by BS, in particular the local BS in the source country (Rosenthal et al. 1999; Ten Kate and Laird 2000; Onaga 2001). By collaborating with international pharmaceutical industries, these BS can enhance their scientific database and biotechnology in sample screening via a set of non-monetary benefit-sharing terms in the contract, including technology transfer, internal personnel training, capacity-building, and sharing of research results and biological databases.

For instance, sharing databases on the indigenous genetic resource and chemical structure of the samples provided by the BS can directly provide useful, valuable information for the efficient design of future sample guidelines. In other words, this contributes to fine-tuning the scope sample collection activities, saving money by avoiding unnecessary field collection for genetic resources. Moreover, the shared technology can improve the overall sample quality when it is applied to sample extraction and screening. This will not only contribute to increasing the probability of

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<sup>4</sup> According to Artuso (2002), the value of raw biological material as an input in the research or production of these products is significantly lower than the value of finished products containing or derived from biochemical resources.

generating success in drug discovery, but also to enhancing the long-term benefits for biodiversity sellers due to the increasing added-value of each sample.

### **2.3. Drug development**

Drug development is usually carried out by the pharmaceutical companies (i.e. the BB) and it is based on pharmaceutical research efforts or commitments (see Figure 1). The first target is to discover productive research leads, associating their role to the reduction of production costs. Another target refers to the greater probability of success in developing a new drug. In both cases, research and innovation activities contribute to increasing the competitiveness of the private company and its products.

Some authors argue that the innovation capability is closely dependent on the research capacity of individual companies as well as on their additional investments in R&D processes (DiMasi et al. 1991; Ten Kate and Laird 1999). The latter, however, requires a strong financial commitment by private companies. Empirical analyses of the estimated R&D costs to develop new drugs consist of the costs related to on-going discovery and development activities, as well as of the costs of failed projects (DiMasi et al. 1991; Simpson et al. 1996). Recent calculation indicates that the largest companies spend more than a billion dollars per year on pharmaceutical research and development activities (ICBG 1997). Finally, in the scenario where R&D is found to be successful, the private company incurs additional costs to apply for approval from the regulatory agency, and royalties.

Independently of the sum of R&D investment, one cannot *ex ante* guarantee the marketable success of each research lead. Instances like INBio and ICBG projects, and marine bioprospecting projects all point out that the current sampling and synthesis techniques are very expensive processes with limited success. Similar findings obtained by Polski (2005) indicate that, in the U.S., on average 10 years are needed to bring a new drug to market at a cost of 800 million dollars. Large amounts of money are spent on research and development, in which only one every 5,000

compounds may be identified and marketed as a drug. Finally, less than 15% of all drugs can generate revenues large enough to compensate the cost of research development (Polski 2005; Standard and Poor's Corporation 2003).

If, however, the R&D succeeds, the private company receives large monetary returns from the successful new commercial product. According to the 1994 statistics of the International Development Research Centre, many of the most commonly used drugs in Western medicine are derived from tropical plants and are worth 32 billion dollars a year in sales worldwide (Merson 2000). In 2002, an estimated 2.4 billion dollars were obtained from global sales of marine biotechnology products (Ruth 2006). This is one of the main incentives for big industries that are keen on investing in bio-prospecting, and that keep land aside for the conservation of the genetic resources for future research.

#### **2.4. The role of Patenting or Intellectual Property Rights**

The issue regarding intellectual property rights (IPR) is central to the debate concerning the utilisation of genetic resources and their derivatives in bioprospecting contracts. In pharmaceutical research in particular, the clear definition of intellectual property rights is essential to facilitate R&D collaboration and to protect knowledge before the formalisation of technology exchange arrangements, so that the security, distribution and exploitation of the initial inventions can be guaranteed by legislations (Thumm 2005).

It is clear that high quality research leads, derived from the extraction, processing and screening activities provided by biodiversity sellers, are the key elements driving the evolution of pharmaceutical research in the context of bioprospecting. As a matter of fact, pharmaceutical research on natural products, according to some authors ( e.g. Simpson et al. 1996), is more often intended to develop “leads” than to identify natural products. Moreover, the IPR on the novel compounds and chemical structures discovered in pharmaceutical research are always associated

with the patenting rights on their downstream applications by the contractual partners. This requires biodiversity sellers to protect the IPR over their new discoveries, and to guarantee the benefits in the form of royalty payments arising from their patented innovations. The royalty payments can therefore be interpreted as the economic price to use the patented research leads and biochemical compounds.

In addition, for the pharmaceutical industry alone, there are significant incentives involved in patenting their product innovations so as to protect past investment efforts and fend off market competitors, e.g. free riders. Generally speaking, internal R&D is a costly activity associated with high risks. Some figures have shown that although there is only a slim probability (about 10 of 10000) that synthesised chemical compounds are successful as market products, pharmaceutical companies have to patent each compound in view of the fact that it might lead to the next blockbuster (Cardinal and Hatfield 2000). Pharmaceutical companies therefore have an increasing need for Intellectual Property Protection so as to obtain high revenues from their new drugs to make up for their large investment efforts and to deal with potential new competitors in the market. In the next section, we shall discuss the role of patenting in more detail.

The effects of IPR have to be analysed from two points of view. On the one hand, patent rights grant the holder exclusion power from research or exclusion power from the market. They encourage the creation of new, economically valuable knowledge and increase competitiveness within an appropriate regulatory framework (Musu 2005; Thumm 2005). On the other hand, many critics believe that the patent system creates entry barriers and overly strong monopoly positions, thus hindering the development of new knowledge (Lawson 2004; Musu 2005; Thumm 2005). In the remaining body of the paper, we attempt to apply a formal economic analysis so as to identify the different patenting schemes involved in pharmaceutical bioprospecting contracts and their economic impacts on stakeholders' objective functions, the overall level of genetic resource protection and human welfare.

### **3. Bioprospecting Contracts: Some Stylised Facts**

The paragraph provides an overview of a selection of existing bioprospecting contracts and an economic analysis of the most important provisions. Stylised facts show that the most frequently adopted governance structure is represented by long-term contracts, mostly signed between public research institutions and biotechnological- pharmaceutical multinationals, all over the world.

A well-known presented case is, for instance, the bioprospecting contract between the INBio-national biodiversity institute of Costa Rica, and Merck Pharmaceutical Ltd. in 1991. Merck was granted the right to evaluate the commercial prospects of a limited number of plant, insect, and microbial samples collected in Costa Rica's 11 conservation areas, from which INBio gained US\$1 million over two years and equipment for processing samples and scientific training from Merck. In addition, the agreement addressed a share of potential royalties and technology transfer to develop local sample preparation and screening capabilities. INBio agreed to invest 10% of all the payments and half of the royalties by Merck into the Conservation Areas (Mulholland and Wilman 1998; Merson 2000; Nunes and Bergh 2001; Artuso 2002). This kind of agreement leads to different interests in genetic resources, crucial input for research and development (R&D), and thus results in different contractual specifications. For instance, industries of botanical medicines, personal care and commercial agriculture traditionally depend upon plant genetic resources, but biotechnological companies and pharmaceutical companies always acquire material as raw samples, extracts from plant genetic resources or 'value-added' genetic resources (Ten Kate and Laird 1999; 2000).

Table 1 contains a review of the most important provisions in a sample of 8 selected contracts, stipulated world-wide.

*Table 1 A review on the existing bioprospecting contracts*

Contractors and Legal Nature of the parties	Date of Signature, Duration and Possibility to Renew	Contract Payment of biodiversity	R&D, Patenting and Biodiversity Protection Obligations	Other Obligations
INBio (national biodiversity institute of Costa Rica, non-profit, public interest organization) &Merck (private company)	1991 (2 years)  Renewable	Lump-sum transfer	- Royalties Sharing -Technology transfer to develop local preparations and screening capabilities - Obligation for the private company to financially contribute to protect biodiversity	No Exclusive contracts - Common use of the resource
ICBG (International Cooperative Biodiversity Group, U.S: governmental venture) & Bristol-Myers Squibb, Monsanto, and Glaxo Wellcome (consortium of private companies)	1993 (5 years)  Renewable	Lump-sum transfer	- No Royalties Sharing - No technology transfer to develop local preparations and screening - Obligation for the private company to financially contribute to protect biodiversity	No Exclusive contracts - Common use of the resource
European botanical Gardens (EU public institutions) & U.S. Phytera (private company)	1996 (11 years)  Renewable	Payment per plant	- Royalties Sharing - No technology transfer to develop local preparations and screening - No Obligation for the private company to financially contribute to protect biodiversity	Exclusive contracts - Common use of the resource
TBGRI (Tropical Botanical Garden and Research Institute in Kerala, public institutions) & Arya Vaidya Pharmacy Coimbatore Ltd (private company)	1996 (11 years)  Renewable	Lump-sum transfer	- Royalties Sharing -Technology transfer to develop local preparations and screening capabilities. Investment in the Kani Community for human capital formation - Obligation for the private company to financially contribute to protect biodiversity	Exclusive contracts - Common use of the resource
Yellowstone National Park (U.S. public institution) & Diversa (private company)	1997 (10 years)  Renewable	Lump-sum transfer	Royalties Sharing - No Technology transfer to develop local preparation and screening capabilities. - No Obligation for the private company to financially contribute to protect biodiversity	No Exclusive contracts - Common use of the resource

Table 1 A review on the existing bioprospecting contracts (cont.)

Contractors and Legal Nature of the parties	Date of Signature, Duration and Possibility to Renew	Contract Payment of biodiversity	R&D, Patenting and Biodiversity Protection Obligations	Other Obligations
CSIR (The Bio/Chemtek division of South Africa's Commission on Scientific and Industrial Research, public institution) & Diversa (private company)	1998 (9 years )  Renewable	No monetary transfer	No Royalties Sharing  Technology transfer to develop local preparations and screening capabilities for traditional healers  No Obligation for the private company to financially contribute to protect biodiversity	Exclusive contracts  - Common use of the resource
Brazilian Extracta (public institution) & Glaxo Wellcome (private company)	1999 (3 years)  Non Renewable	Lump-sum transfer	Royalties Sharing  Technology transfer to develop local preparation and screening capabilities  Obligation for the private company to financially contribute to protect biodiversity	No Exclusive contracts  - Common use of the resource
Department of Chemistry University of South Pacific (public institution) & Smith Kline Beecham (private company)	1995 (3 years)  Renewable	Non Monetary	Royalties Sharing  Technology transfer to develop local preparation and screening capabilities. Investment in the Verata Community for human capital formation  Obligation for the private company to financially contribute to protect biodiversity	Exclusive contracts  - Common use of the resource

Sources: (Breibart 1997; ICBG 1997; Mulholland and Wilman 1998; Neto and Dickson 1999; Ten Kate and Laird 1999; Merson 2000; Artuso 2002; Greer and Harvey 2004; Dedeurwaerdere et al. 2005)

Though very different in peculiarities, the selected contracts present a set of common features and provisions.

First, despite the various entities of the existing bioprospecting contracts, and the wide range of stakeholders, it is possible to identify two main parties to the agreement.

- 1) *Biodiversity Sellers* (BS) are generally public institutions of various types (e.g. botanic gardens, universities, research institutions, and gene banks). The BS have an important role



as contractors with the (pharmaceutical) private companies, since they serve private companies with the screened samples, novel compounds and discovered research leads derived from their field collections in association with the appropriate freedom for new drug development. In addition, they are responsible for obtaining a granted permission of access to genetic resources, or indigenous knowledge, and collaborate with the private companies in the development and marketing of these resources. In doing this, they have to enter into separate contracts or other agreements with both source suppliers and private companies. In addition, BS (formally or informally) negotiate with the *source suppliers*<sup>5</sup> so as to obtain the permission to exploit the access to the genetic resource. Such permission, therefore, enables BS to conduct field collection.

- 2) *Biodiversity Buyers* (BB) are mostly pharmaceutical multinational companies and represent another contractual party. This stakeholder is characterised by its notable research and development (R&D) efforts on the commercial use of the genetic resources. Although various private companies build their business on the commercialisation of genetic resources, the pharmaceutical industry undoubtedly represents the largest global market. Some figures indicate that global sales of pharmaceuticals are estimated to exceed \$300 billion per annum. The component of sales derived from genetic resources or pure natural products accounts for some \$75-150 billion (Grifo et al. 1997; Ten Kate and Laird 1999). Pharmaceutical multinational companies invest a higher proportion of their sales in R&D than most other industries, such as botanical medicines, personal care, commercial agriculture, and crop protection companies, but they also incur a higher risk in drug discovery and development process (See Table 2). For this reason, pharmaceutical

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<sup>5</sup> *Source suppliers* have been defined in section 2. This group formally consists of source countries' governments, local management entities and indigenous people/communities (e.g. the Kanis), some of which have the ability to grant permission for the access to, and use of, genetic resources and their derivatives, such as the national governments/organisations (e.g. Brazilian Extracta). Source suppliers also include the stakeholder groups that have access to traditional knowledge, on the basis of which the private companies may directly profit or make new and improved products (e.g. CSIR South Africa). For further information, see Nunes *et al.* (2006).

companies play a crucial role as steering engines in driving the progress of bioprospecting contracts. The next section focuses on the economic analysis of the pharmaceutical industry only, where the stakeholders originally referred to as BB will represent the pharmaceutical companies/industry.

*Table 2 Comparison of duration and cost of typical research and development programmes in different industry sectors.*

Sector	Years to develop	Cost (US\$ m)
Pharmaceutical	10-15 or more	231-500
Botanical medicines	Less than 2 to 5	0.15-7
Commercial agricultural seed	8 to 12	1-2.5
Transgene	4 or more	35-75
Ornamental horticulture	1 to 20 or more	0.05-5
Crop Protection	2 to 5 (biocontrol agent)	1-5
	8 to 14 (chemical pesticide)	40-100
Industrial enzymes	2 to 5	2-20
Personal care and cosmetic	Less than 2 to 5	0.15-7

*Source:* Ten Kate and Laird 1999, page 9

Second, the agreements' core provision is an exchange obligation: parties trade the possibility to get screened samples of biological material in exchange for a monetary payment (in some cases this is not due) and some other mutual obligations. There are three essential contractual obligations:

- 1) the possibility (or not) to share royalty revenues if the pharmaceutical multinationals patent a new drug discovery thanks to the R&D activities performed on the genetic material sold in the contract;

- 2) the possibility (or not) for the pharmaceutical multinationals to transfer R&D technology and screening capabilities to the local institutions; and/or the possibility (or not) to train (?) local human capital;
- 3) the possibility (or not) for the pharmaceutical multinationals to financially contribute to protect biodiversity with the partial transfer of the royalty revenues.

Moreover, contracts generally include ancillary provisions like the possibility to share the use of the resource and the attribution (or not) of exclusive exploitation rights.

Third, all the contracts are long-term and (mostly) renewable. This contractual feature is well explained by Transaction Cost Economics<sup>6</sup> (TCE) that acknowledges the role of contract terms in *ex ante* aligning marginal incentives and in preventing wasteful efforts to *ex post* redistribution of existing surplus. In order to achieve this twofold objective, contract terms have several dimensions (price provisions; incompleteness level; duration) that allow the transaction(s) at stake to adapt to the regulated contingencies and circumstances. From this perspective, long-term contracts represent the most effective cost-minimising structure to govern transactions. When uncertainty, complexity and asset specificity<sup>7</sup> are significant, internal organisation (and/or long-term contracts) is likely to

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<sup>6</sup> Firms and markets are different, alternative governance structures and the existence of one or the other depends on how transaction costs are minimised. Transaction costs characterise market activities (a transaction is defined as any use of the market, whether for buying or selling). “*There is a cost of using the price mechanism. By forming an organisation and allowing some authority (an entrepreneur) to direct the resources, certain marketing costs are saved*”. The essential reasoning presented by Coase (1937) is an equilibrium condition: “*a firm will tend to expand until the cost of organising an extra transaction within the firm becomes equal to the costs of carrying out the same transaction by means of an exchange on the open market or the costs of organising in another firm.*” In Williamson’s framework (1975, 1979, 1983, 1985), there is no simple dichotomy between market transactions and internal organisation. Rather, there is a continuum, with simple spot market transactions at one extreme, internal organisation (horizontal and vertical) at the other, and a wide range of more complicated contractual relationships in between. Transaction costs depend on transactions uncertainty, opportunistic behaviour, asset specificity and bounded rationality

<sup>7</sup> Williamson identifies four types of asset-specificity:

1. *site-specificity*: once sited the assets are very immobile.
2. *physical asset specificity*: when parties make investments in machinery or equipment that are specific to a certain transaction and these have lower values in alternative uses.
3. *dedicated assets*: general investment by a supplier or buyer that would otherwise not be made but for the prospect of transacting a specific (large) amount an item with a particular partner. If the contract is prematurely terminated, the supplier (who invested) would be with excess capacity/ the buyer would be with unexpected excess demand.
4. *human asset specificity*: workers’ acquired skills, know-how and information that is more valuable inside a particular transaction than outside it.

be a superior arrangement for governing transactions. On the contrary, the market will represent the most efficient form of governance, when uncertainty and asset specificity are not important and transactions are not complex. In this case, contract terms are simple and approximate spot market transactions.

According to the TCE approach, the contracting parties involved in a specific relationship use vertical integration and long-term contracts to limit *ex post* bargaining inefficiencies due to hold-up, thereby minimising the resulting loss in *ex ante* investment. This approach predicts a positive correlation between vertical integration (and/or long-term contracts) and the degree of relation specificity. Vertical integration should enhance both parties' investments positively in the TCE approach.

Bioprospecting activities are certainly characterised by high levels of asset specificity, in particular site specificity, since particular genetic materials are sited in particular locations, and dedicated assets, since the pharmaceutical companies invest in bioprospecting to exploit the possibility of patenting new discoveries. In addition, bioprospecting is characterised by a high level of uncertainty, because firms investing in R&D are uncertain of the probability of new drug discoveries. Finally, bioprospecting is characterised by high levels of complexity, because it is an activity generating several (positive and negative) impacts on biodiversity exploitation, on research, on innovation, on firms' competitiveness, on wealth redistribution.

Long-term contracts represent a way to minimise transaction costs, generated by uncertainty, asset specificity and complexity in bioprospecting. Moreover, long-term contracts minimise bureaucratic and administrative transaction costs that could be generated by other organisational forms (public tenders, public authorisations implemented by countries with sovereign property rights over the biodiversity within their jurisdiction), thus providing proper incentives for

pharmaceutical multinationals to invest in R&D, and bringing along the benefits prescribed for the CBD.

Finally, the contracts prescribe for the payment of a biodiversity price, whose amount and payment scheme is different in every contract<sup>8</sup>. For example, Merck paid US\$ 1,135 (correct?) million to INBio for the supply and screening of samples, while U.S. Phytera agreed to pay \$15 per plant to the EU botanical gardens. In addition, the parties agree to share (in different proportions) the returns of the royalties should the bioprospecting activities generate a drug and thus obtain a discovery patent. Some other contracts do not provide for monetary transfers (for instance, the collaboration between the traditional healers and CSIR in bioprospecting has only promoted the development of a data base of information on the traditional uses of South African plants, which can help CSIR and its partners to make a preferential selection on the plants for screening. Moreover, a formal agreement grants the application of benefit-sharing arrangements among the contractors.

#### **4. Modelling Bioprospecting Contracts**

This section provides a theoretical economic perspective to identify, characterise and discuss the interrelationships between contractors which are governed by bioprospecting contracts. The setting and setup of the contracts is interpreted as a key element in revealing the underlying motivations that induce the interested parties to subscribe to bioprospecting. As a consequence, the contract improves our understanding of the strategic behaviour of contractors, and ultimately allows us to evaluate the performance of bioprospecting contracts.

Bioprospecting contracts aim at ensuring the exclusive access to the genetic resources, based upon the equitable and fair sharing of the benefits between the involved parties. This access can be

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<sup>8</sup> In a TCE approach, the contract price reflects the parties' evaluation of the contract

facilitated by a set of other accessory negotiations (for instance, authorisations/or collateral agreements concerning the provision, or transfer, of the samples, chemical compounds and genetic information derived from extracting and screening activities in the research institutes or universities) with third interested parties (for instance local populations).

It therefore links the biodiversity sellers with the private companies through a set of mutual agreements on the sharing of both monetary and non-monetary benefits on the use of genetic materials and their derivatives.

Originally, collection, discovery and development were sequential processes in pharmaceutical research, but they now tend to be conducted in parallel by both the pharmaceutical industry and some collaborative institutions in order to reduce the development time. The industry alone is responsible for conducting the drug development, but sometimes requires the biodiversity sellers (that usually are public research institutions in the source country) to complete the fundamental research for drug discovery, including the field collection, establishment of screening libraries, and discovery of active compounds for pharmaceutical research. Hence, pharmaceutical companies are legally entitled to the exclusive use of the given samples in association with the freedom of developing these samples into natural products, research leads or synthetic compounds for new drug discovery.

In the present study, we attempt to provide a formal analysis of the bioprospecting contract, by highlighting the objective functions and objective function maximisation of the two main parties, in order to provide a primer theoretical structure to the contract and to analyse the main (market) impacts (for a theoretical study of contracts in the electricity and art markets, see Onofri, 2003(a) and (b)). The impact of patents will be formalised in terms of their specific effects on the parties and considerations, and respective impacts on the costs and benefits for all the involved contractors. In the next subsections, we shall identify and assess the magnitude of such impacts.

#### 4.1 Modelling the biodiversity seller's objective function

Given the condition that biological material suppliers voluntarily accept contractual bioprospecting activities, the contract supply function for the biodiversity sellers (BS) can be formally expressed by

equation (1):

$$y_{BS} = F(s(\underline{\theta}), L(B; \underline{\theta}), T(B; \underline{\theta})) \quad (1)$$

As we can see, the contract supply function is modelled as dependent (a) on the stock of genetic material available to the seller, denoted by  $s$ ; (b) on the human efforts, denoted by  $L$ ; and technology, denoted by  $T$ . For the sake of simplicity, we assume that the seller does not pursue autonomous R&D activities, meaning that  $T$  is not a direct control variable. However, it can benefit from non-monetary sharing-benefits, such as technology transfer (e.g. funding of laboratory equipment, modifications and maintenance; funding of computer system), that may come along with the signature of the contract, and for this same reason  $T$  is modelled as dependent on  $B$ , the amount of the parties' bioprospecting effort (resulting in a number of pre-screened samples to trade with the buyer) as established in the contract. Similarly, the signature of the contract can also provide non-monetary benefits by improving the quality of the human capital employed in the screening sampling process (e.g. formal training at local Universities and access to scientific literature). Furthermore, here  $\underline{\theta} \equiv (\theta_L, \theta_T)$  denotes a vector portraying a set of idiosyncratic characteristics associated with the seller supply, including the quality of the local labour involved in the sampling procedures,  $\theta_L$ ; the degree of access to technology as well as the quality of genetic material collected from the source country,  $\theta_T$ . These characteristics will be embedded in the transaction specificity and reflected on the contractual seller's position. This will be then signaling

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the seller's bargaining power and the price of the contract<sup>9</sup>. At this stage, we can model the expected profits<sup>10</sup> of the BS as follows:

$$\pi_{BS} = p_B(B; \theta) \cdot F(s(\theta), L(B; \theta), T(B; \theta)) - C(s, L, T, B) + \mu Roy(pat) \quad (2)$$

In first term in equation (2),  $p_B$  denotes the price of the contract. As explained before, price is assumed to be dependent on the idiosyncratic characteristics of the BS. The second term captures the production and transaction costs. This term includes the costs regarding the access to the resources (e.g. when the material is not at the seller's disposal this may refer to the costs of the negotiations for authorisations with the local communities), the costs of labour and technology employed by the seller, as well as the costs of negotiating, writing and enforcing the bioprospecting contract. We assume that the cost function is characterised by economies of scale. In particular, we assume that  $\delta C / \delta B > 0$  and  $\delta^2 C / \delta B^2 > 0$ .

Finally, the last term in equation (2), denotes the royalty benefits on the basis of the expected value of a successful pharmaceutical product derived from the supplied patented compounds. The parameter  $\mu$  (with  $0 < \mu \leq 1$ ) represents the share from patent revenues that the BS will receive. Against this background, the BS maximises its profits by choosing *inter alia* the amount of parties' bioprospecting effort as established in the contract, i.e.  $B$ . Formally, we have

<sup>9</sup> In this paper, the issue of the contractors' bargaining power is voluntarily left as an "open" matter because of our selected methodological inductive approach. We attempt to capture common features in selected, very different bioprospecting contracts (whose parties will have different bargaining power, case by case). An alternative methodological approach is the one provided by Gatti et al. (2005), that employ cooperative bargaining theory, to examine whether bioprospecting contracts create incentives for protection of rich biodiversity lands. Building on Nash's idea of 'rational threats', the authors demonstrate that rather than removing the strategic incentives in the game of surplus division, current arrangements may, in fact, generate such incentives.

<sup>10</sup> Generally speaking, patenting may also cover a class of genetic materials and their broad applications (Lawson 2004). It must therefore lead to a more active patenting behavior in response to the application or imitation of the patented inventions by the external collaborators and competitors. Therefore, the BS has the possibility to patent new biological components discovered during the screening process. This is not modeled because it is not the object of the formal bioprospecting contract, core of the present analysis.

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$$\underset{B}{Max} \quad \pi_{BS} = p_B(B; \underline{\theta}) \cdot F(s(\underline{\theta}), L(B; \underline{\theta}), T(B; \underline{\theta})) - C(s, L, T, B) + \mu \cdot E[Roy(pat)] \quad (3)$$

The first order condition is:

$$\frac{\partial \pi_{BS}}{\partial B} = p_B \left[ \frac{\partial F}{\partial L} \frac{\partial L}{\partial B} \theta_L + \frac{\partial F}{\partial T} \frac{\partial T}{\partial B} \theta_T \right] + y_{BS} \frac{\partial p}{\partial B} \theta - \frac{\partial C}{\partial B} = 0 \quad (4)$$

In other words, the optimal  $B^*$  for the BS must satisfy equation (4). Equation (4) states that the seller is willing to write the bio-prospecting contract until the marginal benefits resulting from this action are equal to the marginal costs. According to equation (4), the marginal benefits are captured by two separate components: non-monetary benefit transfer and contract price. The first component refers to  $p_B \left[ \frac{\partial F}{\partial L} \frac{\partial L}{\partial B} \theta_L + \frac{\partial F}{\partial T} \frac{\partial T}{\partial B} \theta_T \right]$ . As we can see, this value depends on the qualitative changes of the value of productivity that the contract can bring along with it due to the transfer of technology and education. This magnitude is dependent on the parameters  $\theta_L$  and  $\theta_T$ , and thus reflecting the idiosyncratic characteristics of the BS with respect to the two inputs under consideration. The second component refers to the potential effect of the idiosyncratic characteristics of the BS on the definition of the price of the contract, signaling the seller's bargaining power,  $y_{BS} \frac{\partial p}{\partial B} \theta$ . The magnitude of these benefits needs to be compared with the marginal costs associated to parties' bioprospecting effort, the negotiating, writing and enforcing of such a contract, i.e.  $\frac{\partial C}{\partial B}$ . Furthermore, we can highlight the following different scenarios regarding the magnitude of the two main effects of the benefit components:

(a) when  $p_B \left[ \frac{\partial F}{\partial L} \frac{\partial L}{\partial B} \theta_L + \frac{\partial F}{\partial T} \frac{\partial T}{\partial B} \theta_T \right]$  is larger than  $y_{BS} \frac{\partial p}{\partial B} \theta$ , with  $y_{BS} \frac{\partial p}{\partial B} \theta \cong 0$ , then we can

interpret this situation as signalling that the BS strongly values the non-monetary benefits that the bioprospecting contract brings, even if the BS does not have a strong bargaining power. This situation is illustrated, for example, in the *CSIR & Diversa* contract (see Table 1);

(b) alternatively, when  $y_{BS} \frac{\partial p}{\partial B} \theta$  is larger than  $p_B \left[ \frac{\partial F}{\partial L} \frac{\partial L}{\partial B} \theta_L + \frac{\partial F}{\partial T} \frac{\partial T}{\partial B} \theta_T \right]$ , with

$p_B \left[ \frac{\partial F}{\partial L} \frac{\partial L}{\partial B} \theta_L + \frac{\partial F}{\partial T} \frac{\partial T}{\partial B} \theta_T \right] \cong 0$ , then we can interpret this scenario as signalling that the BS

attaches a significant value to the monetary component of the marginal revenues from the contract. This situation is illustrated, for example, in the *Yellowstone & Diversa*, *ICBG & Bristol-Myers Squibb-Monsanto-Glaxo Wellcome* and *European Botanical Gardens & US Phytera* contracts (see Table 1).

#### 4.2 Modelling the biodiversity buyer's objective functions

The production function for the biodiversity buyer (BB) can be described by the following equation:

$$y_{BB} = G[y_{BS}(B; \underline{\sigma}), K(B; \underline{\sigma}), TI(pat(B); \underline{\sigma})] \quad (5)$$

in which,  $y_{BB}$  is the yield of successfully developed drugs by the pharmaceutical company, which is modelled as a function of the screened genetic material supplied, as foreseen in the contract and denoted by  $y_{BS}$ , the accumulated knowledge in the R&D process, denoted by  $K$ , and technological investments, denoted by  $TI$ .  $K$  has a positive effect on  $y_{BB}$  since it plays an important role in increasing the probability of successfully developing new drugs. In a similar way,  $TI$  positively influences the productivity of the pharmaceutical industry. It however, relies on the

patentable innovations in the drug development process or the new products subject to the effort in writing a bioprospecting contract. For this reason, this effect is expressed in equation (5) as  $TI(pat(B))$ . Finally, the idiosyncratic characteristics of the BB are captured by the term  $\underline{\sigma}$  and can be interpreted *inter alia* in terms of the BB's capability of undertaking R&D, market share in the world market of drugs and medicines (and embedded market power). Therefore, the objective function of the BB can be modelled as follows:

$$\pi_{BB} = P_D \cdot G[y_{BS}(B;\underline{\sigma}), K(B;\underline{\sigma}), TI(pat(B);\underline{\sigma})] - C(y_{BS}, B, TI, pat) + (1-\mu)E[Roy(pat(B);\underline{\sigma})] \quad (6)$$

The first term,  $P_D \cdot G[y_{BS}(B;\underline{\sigma}), K(B;\underline{\sigma}), TI(pat(B);\underline{\sigma})]$  in the equation (8) represents the total revenues of successful new drugs in the market.  $P_D$  represents the market price of the drug, which is at this stage assumed to be exogenous to the BB (later we shall relax this assumption). The second term calculates the total costs incurred by the pharmaceutical company:  $C$  denotes the total costs, including the costs in purchasing screened samples from the BS, transaction costs, continual investments in R&D, and the costs of patent application and renewal fees for the new drug products. Finally,  $(1-\mu)E[Roy(pat(B);\underline{\sigma})]$  is the BB's share of the expected royalties. Hence, the company can maximise its net benefits through the choice of  $B$ ,  $TI$ , and  $pat$ .

$$\begin{aligned} \underset{B, TI, pat}{Max} \quad \pi_{BB} = & P_D \cdot G[y_{BS}(B;\underline{\sigma}), K(B;\underline{\sigma}), TI(pat(B);\underline{\sigma})] - C(y_{BS}, B, TI, pat) + \\ & + (1-\mu)E[Roy(pat(B);\underline{\sigma})] \end{aligned} \quad (7)$$

The three first order conditions are

$$\frac{\partial \pi_{BB}}{\partial B} = P_D \left[ \frac{\partial G}{\partial y_{BS}} \frac{\partial y_{BS}}{\partial B} \sigma + \frac{\partial G}{\partial K} \frac{\partial K}{\partial B} \sigma_K + \frac{\partial G}{\partial y_{TI}} \frac{\partial TI}{\partial pat} \frac{\partial pat}{\partial B} \sigma_{pat} \right] - \frac{\partial C}{\partial B} + \quad (8)$$

$$+ (1-\mu)E \left[ \frac{\partial Roy}{\partial pat} \frac{\partial pat}{\partial B} \sigma_{pat} \right] = 0$$

$$\frac{\partial \pi_{BB}}{\partial TI} = P_D \frac{\partial G}{\partial TI} - \frac{\partial C}{\partial TI} = 0 \quad (9)$$

$$\frac{\partial \pi_{BB}}{\partial pat} = P_D \frac{\partial G}{\partial y_{TI}} \frac{\partial TI}{\partial pat} \sigma_{pat} - \frac{\partial C}{\partial pat} + (1-\mu)E \left[ \frac{\partial Roy}{\partial pat} \sigma_{pat} \right] = 0 \quad (10)$$

Therefore, the BB optimal levels of  $B^*$ ,  $K^*$ , and the optimal effort in getting a patent,  $pat^*$ , must simultaneously satisfy equations (8)-(10). Equation (8) states that the BB intends to stipulate the bioprospecting contract, if and only if, the actual marginal revenues, denoted by

$$P_D \left[ \frac{\partial G}{\partial y_{BS}} \frac{\partial y_{BS}}{\partial B} \sigma + \frac{\partial G}{\partial K} \frac{\partial K}{\partial B} \sigma_K + \frac{\partial G}{\partial y_{TI}} \frac{\partial TI}{\partial pat} \frac{\partial pat}{\partial B} \sigma_{pat} \right],$$

plus the expected marginal revenues, denoted by  $(1-\mu)E \left[ \frac{\partial Roy}{\partial pat} \frac{\partial pat}{\partial B} \sigma_{pat} \right]$ , arising from the selling of drugs obtained by the

transformation of the screened samples, which are purchased in the bioprospecting contract, can

fully offset the marginal costs of writing this contract,  $\frac{\partial C}{\partial B}$ . Equation (9) states that the optimal

amount of investment is determined by the marginality condition. More interestingly, Equation (10)

shows that the BB has the incentive to patent its new products, and pharmaceutical inventions, as

long as its financial returns, which are expressed in terms of the value of increasing productivity,

$$P_D \frac{\partial G}{\partial TI} \frac{\partial TI}{\partial pat} \sigma_{pat},$$

plus the additional, potential effect that patenting will bring on the expected royalty payoff,  $(1-\mu)E \left[ \frac{\partial Roy}{\partial pat} \frac{\partial pat}{\partial B} \sigma_{pat} \right]$ , are larger than the total costs of patenting,  $\frac{\partial C}{\partial pat}$ . It is

clear from Equation (10) that patenting has a positive impact on investments in technology, since the research discoveries and pharmaceutical innovations are protected by the legislation. As a consequence, the large investments will bring about rapid progress in the present technology for drug development, which in turn, can increase the utilisation potential of genetic resources and their value due to the reduced time and costs in screening for pharmaceutical and other uses (Craft and Simpson 2001). Moreover, we can also consider the scenario where patenting may lead to create a monopolistic position for the BB. In this case, the BB will significantly increase its market power. This will be reflected in the possibility to set the drug market price. In formal terms, this is defined by:

$$\lambda = \frac{P_D(y_{BB}, pat) - P_D(y_{BB})}{P_D(y_{BB}, pat)} \quad (11)$$

with  $\lambda > 0$ ,  $P_D(y_{BB}, pat) > P_D(y_{BB})$  and  $P_D(y_{BB}) \equiv P_D(y_{BB}, pat = 0)$

According to equation (11), patenting the new pharmaceutical products and innovations is responsible for the determination of a “monopolistic price overcharge”, whose magnitude is captured by  $\lambda$ , also denoted in the literature as price mark-up. Against this background, we can rewrite equation (10) as

$$\frac{\partial \pi_{BB}}{\partial pat} = P_D \frac{\partial G}{\partial y_{BB}} \frac{\partial TI}{\partial pat} \sigma_{pat} + \frac{\partial \lambda}{\partial pat} y_{BB} - \frac{\partial C}{\partial pat} + (1 - \mu) E \left[ \frac{\partial Roy}{\partial pat} \sigma_{pat} \right] = 0 \quad (12)$$

Therefore, when the BB is legally allowed to patent the product, this effect can be used by the company as a tool to increase its market power, and thus earn greater profits. The magnitude of this

effect is given by  $\frac{\partial \lambda}{\partial pat} y_{BB}$ . This constitutes an additional incentive for the private company to endorse R&D, which was not originally foreseen in equation (10).

### 3. Discussion of the impacts of bioprospecting contracts and patenting on welfare

In the previous sections we have shown that bioprospecting contracts and patenting are significant variables affecting the objective functions of the parties under consideration. The prospect of higher individual profits, and market power, can stimulate the BS and BB to endorse bioprospecting and BB to endorse patenting. The following analysis will formally assess the total welfare impacts involved and their distribution among the stakeholders. Let us assume that the total welfare function is given by the following Samuelson-Bergson additive function:

$$\begin{aligned}
W &= \pi_{BS} + \pi_{BB} + v(x, y_{BB}, S) \\
W &= p_B(B; \underline{\theta}) \cdot F(s(\underline{\theta}), L(B; \underline{\theta}), T(B; \underline{\theta})) - C_{BS}(s, L, T, B) + \mu \cdot E[Roy(pat)] + \\
&+ P_D(y_{BB}, pat) \cdot G[y_{BS}(B; \underline{\sigma}), K(B; \underline{\sigma}), TI(pat(B); \underline{\sigma})] - C_{BB}(y_{BS}, B, TI, pat) + \\
&+ (1 - \mu)E[Roy(pat(B); \underline{\sigma})] + v(x, y_{BB}(B; pat), B)
\end{aligned}$$

with  $P_D > p_B$

or,

$$\begin{aligned}
W &= P_D(y_{BB}, pat) \cdot G[y_{BS}(B; \underline{\sigma}), K(B; \underline{\sigma}), TI(pat(B); \underline{\sigma})] - C_{BS}(s, L, T, B) - C_{BB}(B, TI, pat) + \quad (13) \\
&+ E[Roy(pat(B); \underline{\sigma})] + v(x, y_{BB}(B; pat), B)
\end{aligned}$$

Equation (13)<sup>11</sup> shows that the welfare function is given by the aggregation of BS and BB objective functions. In addition, we also consider the consumer's utility expressed in monetary terms, denoted by  $v(\cdot)$ . The latter increases with the consumption of all other goods,  $x$ , and the consumption of pharmaceutical products, whose market is characterised by monopolistic power due to patenting. Finally, the consumer's utility is also modelled as depending on  $B$ , and this may be interpreted as signalling consumer's motivation with respect to the writing of the bioprospecting contract in terms of its contribution to the provision of impure altruistic, and/or aesthetic and/or existence values. For example, this may reflect the consumer's *additional* willingness to pay for the market drug in the scenario where he, or she, is guaranteed that the respective production process is characterised by the respect of the knowledge of local communities property rights. For this same reason, the consumer *feels* good when buying this product since he, or she, is *also* "buying" moral satisfaction or warm-glow as derived from such a "good" cause (see Andreoni 1990, Nunes and Schokkaert 2003). Alternatively, this effect may reward the producer's effort to protect the degradation of local biodiversity and respective landscape, including avoiding bio-piracy<sup>12</sup> actions. It is important to note that the price of the bioprospecting contract, or the price of screened samples,  $p_B$ , is assumed to be smaller than the price of the successfully developed drugs,  $P_D$ , which embeds all the information and bio-technology values. The difference can be interpreted as added-value resulting from the efforts that the BS puts forward in order to improve the quality of biotic

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<sup>11</sup> Since the revenue of the BS corresponds to the BB costs of buying screened samples, we can eliminate the first term by deleting the BB cost component with respect to the  $y_{BS}$ .

<sup>12</sup> As an example of biopiracy, we report the following case. In 1995 the U.S. Department of Agriculture and a pharmaceutical research firm received a patent on a technique to extract an anti-fungal agent from the Neem tree (*Azadirachta indica*), which grows throughout India. Indian villagers have long understood the tree's medicinal value. Although the patent had been granted on an extraction technique, the Indian press described it as a patent on the Neem tree itself; the result was widespread public outcry, which was echoed throughout the developing world. Legal action by the Indian government followed, with the patent eventually being overturned. Importantly, the pharmaceutical company involved in the Neem case argued that as traditional Indian knowledge of the properties of the Neem tree had never been published in an academic journal, such knowledge did not amount to "prior art" (*prior art* is the term used when previously existing knowledge bars a patent). In response to biopiracy threats such as this, India has been translating and publishing ancient manuscripts containing old remedies in electronic form. (see Sheva, 2006)

information contained in their supplied samples. As Swanson (1994) noted, information and insurance values are connected with the quality of the genetic resources.

**A) The effects of the contract on social welfare:**

Bearing in mind Equation (13), we are able to express the effect of the contract on social welfare as follows:

$$\begin{aligned}
 dW = P_D & \left[ \frac{\partial G}{\partial y_{BS}} \frac{\partial y_{BS}}{\partial B} \sigma + \frac{\partial G}{\partial K} \frac{\partial K}{\partial B} \sigma_K + \frac{\partial G}{\partial y_{TI}} \frac{\partial TI}{\partial pat} \frac{\partial pat}{\partial B} \sigma_{pat} \right] dB - \frac{\partial C_{BS}}{\partial B} dB - \frac{\partial C_{BB}}{\partial B} dB + \\
 & + E \left[ \frac{\partial Roy}{\partial pat} \frac{\partial pat}{\partial B} \sigma_{pat} \right] dB + \left( \frac{\partial v}{\partial y_{BB}} \frac{\partial y_{BB}}{\partial B} + \frac{\partial v}{\partial B} \right) dB
 \end{aligned}
 \tag{14}$$

Equation (14) shows that the bioprospecting contract has several welfare impacts. A close inspection of this equation shows that most of these are related to the objective function of the BB, see Equation (8). This means that, from the selected welfare perspective, all the benefits that the BS receives from the bioprospecting contracts are balanced by the BB costs of buying screened samples. Therefore, these benefits do not appear in (14), they are simple transfers. However, this component can be of relevance from a distributional point of view. Especially, when the social planner attaches a higher welfare weight to BS, including the evaluation of the non-monetary benefit-sharing effects accrued to the BS (e.g. technology transfer, internal personnel training, capacity-building, and sharing of research results and biological databases). However, this distributional welfare gain might generate additional and significant transaction costs (for instance, the costs of monitoring the contract execution and/or enforcing the contract). This might jeopardise



the efficiency of the governance structure and related efficiency gains and, in turn, drive the contractors to re-adapt to a new governance structure that tends to minimise transaction costs.

In particular, from Equation (14) we can distinguish the following welfare impacts: (a)

$$P_D \left[ \frac{\partial G}{\partial y_{BS}} \frac{\partial y_{BS}}{\partial B} \sigma + \frac{\partial G}{\partial K} \frac{\partial K}{\partial B} \sigma_K + \frac{\partial G}{\partial y_{TI}} \frac{\partial TI}{\partial pat} \frac{\partial pat}{\partial B} \sigma_{pat} \right],$$

which corresponds to the BB marginal revenues effects; (b)  $E \left[ \frac{\partial Roy}{\partial pat} \frac{\partial pat}{\partial B} \sigma_{pat} \right]$ , which corresponds to the expected marginal royalty

revenues, that will be distributed among the BS and BB according to the  $\mu$  share. The higher the  $\mu$ , the higher the transfer of expected marginal royalty revenues to the BS. In addition, we can see that the contract has two effects on the consumer's utility and, thus, welfare. First, such effects refer to the impact of the bioprospecting contract on the supply of the drugs in the market, i.e.

$$\frac{\partial v}{\partial y_{BB}} \frac{\partial y_{BB}}{\partial B}. \text{ Since the marginal utility of the consumption of the drugs is non-negative, } \frac{\partial v}{\partial y_{BB}} \geq 0,$$

and the marginal effect of the bioprospecting contract on the production of drugs is also non-negative,  $\frac{\partial y_{BB}}{\partial B} \geq 0$ , we can expect this effect to be positive. Second,  $\frac{\partial v}{\partial B}$  captures the marginal

impacts of the bioprospecting contract in terms of impure altruistic, aesthetic and/or existence values to the consumers. Finally,  $\frac{\partial C_{BS}}{\partial B}$  and  $\frac{\partial C_{BB}}{\partial B}$  show that contracting is a costly activity for

both BS and BB, respectively, and thus negatively affects the welfare function.

To conclude, the overall effect on social welfare is unknown, but most likely expected to be positive. This positive effect is strengthened by three main determinants: (1) the lower the transaction cost; (2) the higher the benefit of the contract in terms of BB productivity and potential royalty revenues; and (3) the higher the consumer's valuation of the contract. The combination of these results confirms the theoretical validity of the stylised facts discussed in Section 2, where contracts were interpreted as cost-minimising governance structures to implement the CBD principle. Against this background, the suggested policy recommendation is to respect the 'invisible

hand' mechanism and let the contracts work, since according to TCE biodiversity sellers and biodiversity buyers are the most proper agents to efficiently adapt to transaction costs.

**B) The effects of patenting on social welfare:**

Bearing in mind Equation (13), we are able to express the effect of the contract on social welfare as follows:

$$dW = \left[ P_D \frac{\partial G}{\partial y_{TI}} \frac{\partial TI}{\partial pat} \sigma_{pat} + \frac{\partial \lambda}{\partial pat} y_{BB} \right] dpat + E \left[ \frac{\partial Roy}{\partial pat} \sigma_{pat} \right] dpat + \frac{\partial v}{\partial y_{BB}} \frac{\partial y_{BB}}{\partial pat} dpat - \frac{\partial C}{\partial pat} dpat \quad (15)$$

where we have  $-\frac{\partial C}{\partial pat} < 0$ . This is interpreted as a negative impact on the social welfare and

indicates the relevance of the costs of patent application and renewal fees for the new drug products. In addition, patenting generates the following welfare impacts. First, the expression

$P_D \frac{\partial G}{\partial y_{TI}} \frac{\partial TI}{\partial pat} \sigma_{pat}$  refers to welfare benefits from patenting due to technological investments and

respective productivity, and thus profitability, of the pharmaceutical sector. This may well signal

the well-known literature effect that points out that patents create incentives for R&D (see Heller and Eisenberg 1998; Willison and MacLeod 2002). In this context, patents do encourage research

and may be essential for the success of drug development (Peeters and Van Pottelsberghe De La

Potterie 2006). Second, patenting is also responsible for the creation of a monopolistic market. A

patent holder achieves the monopolistic profits by being the only producer of the products since the

patent represents a legal barrier to entry. This effect is captured by  $\frac{\partial \lambda}{\partial pat} y_{BB}$ , which is interpreted as

having a positive impact on social welfare. On the other hand, the positive effects of patenting on

the BB's profits are counterbalanced by the negative impacts on consumer surplus. This effect is

expressed by  $\frac{\partial v}{\partial y_{BB}} \frac{\partial y_{BB}}{\partial pat}$ , where the term  $\frac{\partial y_{BB}}{\partial pat}$  is negative since higher prices (and thus lower quantities) due to patenting and applied by the BB monopolist will negatively affect consumer surplus.<sup>13</sup> Finally, the patenting generates a financial revenue in terms of royalty payments, captured by  $\frac{\partial Roy}{\partial pat} \sigma_{pat}$ , which is interpreted as having a positive impact on social welfare. From the theoretical point of view, we cannot establish *a priori* the overall effect (sign) of patenting on social welfare. The respective magnitude is a matter of empirical research.

## 5. Conclusions

The present paper contains an economic analysis of bioprospecting contracts. Given the background information of pharmaceutical research and related bioprospecting activities, we first reviewed a number of existing contracts worldwide in order to identify the main provisions and parties, namely biodiversity seller (e.g. local governmental and/or international research institution) and biodiversity buyer (e.g. private pharmaceutical company). Furthermore, we interpreted contracts in the perspective of transaction costs theory. We then identified the pharmaceutical industry as a private sector involved in bioprospecting activities, representing the largest global market of genetic resource products. For this same reason, this stakeholder is identified as having an important role in formulating the current bioprospecting contracts on the commercial use of genetic resources. Hence, we shifted our research emphasis on the pharmaceutical industry.

By clarifying the pharmaceutical research process and the specific contractors, we gained insight into the contract contents and the bioprospecting activities. These studies provide the grounds for modelling the contractors' objective functions and respective welfare impacts. Our analysis provided the following results. First, long-term bioprospecting contracts were found to be

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<sup>13</sup> Furthermore, since patenting is here associated to the presence of a bioprospecting contract, in order to derive the net consumer surplus one needs to take into account the positive effects in to consumers in terms of impure altruistic, aesthetic and/or existence values, as described in the previous paragraph.

an efficient transaction cost-minimising governance structure for the involved parties. Second, modelling bioprospecting contracts has allowed us to create an original theoretical framework, that explains the observed stylised facts, and to study and capture the different components of the parties' objective functions. Third, comparative static analysis revealed that the governance structure has different, mixed impacts on social welfare. This is because the positive impacts delivered by bioprospecting contracts are associated with the potential discovery of a new drug product, productivity gains, non-monetary benefit sharing or transfers and royalty revenues. The negative welfare impacts are derived from patenting activities which allow the legal creation of a monopoly and the related well-known effect on the consumer surplus. Finally, the potential redistribution effects are limited, and a potential enforcement of this objective may jeopardise the desirability of the contract since this action would lead to a significant increase in the transaction costs.

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