

# Reflections on the European Commission's draft Merger Guidelines

## Assessments of efficiencies in practice

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The draft Merger Guidelines represent a statement of intent by the European Commission on its future approach to, *inter alia*, merger efficiencies. But for the next transaction that raises difficult questions of competitive harms and benefits, do the draft Guidelines provide clear and practical guidance for stakeholders? Following the initial reflections by Compass Lexecon authors on the draft Merger Guidelines as a whole,<sup>1</sup> **Elena, Segye, Zita, and Timo** look at the discussion of efficiencies specifically, sharing their views on the way it may shape merger assessment in practice.

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### Introduction

The draft Merger Guidelines reflect a broad attempt to modernise merger control in light of increasing emphasis on innovation, investment, resilience, and competitiveness. One of the most significant and difficult aspects of this exercise concerns dynamic efficiencies.

Dynamic efficiencies are central to many of the transactions that matter most in modern economies, particularly in innovation-intensive sectors. At the same time, they are inherently uncertain and difficult to quantify. Any attempt to provide meaningful guidance therefore involves a delicate balance: setting sufficiently clear expectations for parties and practitioners, while preserving enough flexibility for the Commission to assess the specific economic realities of individual cases.

In our view, the draft Guidelines broadly strike the right balance. While some aspects of the framework would benefit from further clarification or refinement, the Commission has rightly resisted the temptation to adopt an overly prescriptive approach in an area where the economic methodology is still evolving and decisional practice is scarce.

In this note, we make four observations relating to the treatment of dynamic efficiencies in the draft Merger Guidelines.

- a. **The approach to balancing benefits and harms as described in the draft Guidelines is pragmatic** and consistent with the established logic of merger assessment. As noted above, while it makes sense to avoid overly prescriptive guidance and the draft Guidelines strike the right balance in this respect, **the implications of this framework will depend to a large extent**

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<sup>1</sup> <https://www.compasslexecon.com/insights/publications/reflections-on-the-european-commissions-draft-merger-guidelines-where-should-we-focus>

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**on the Commission’s methodological choices** (e.g., time horizon and discounting) **when it conducts merger assessments in practice.**

- b. Consistent with the broader logic of the draft Guidelines, **symmetry should apply to the assessment of both harms and benefits when considering innovation processes versus outcomes.** Given that the Commission intends to assess anticompetitive effects by reference to their impact on the innovation *process*, merger-specific efficiencies in the form of innovation benefits should be similarly evaluated based on their expected effects on innovation incentives, capabilities and rivalry, without requiring proof of specific future *outcomes*.
- c. There is tension between the draft Guidelines’ ambition to capture novel types of merger benefits and the condition that, for efficiencies to count, benefits must accrue (largely) to the same set of customers who may be harmed. Given the public good characteristics of increased innovation, sustainability and resilience, as well as the fact that the most disruptive innovations tend to generate new markets, **there is a risk that novel categories of efficiencies are recognised in principle but remain largely incapable of influencing merger outcomes in practice.**
- d. The explicit discussion of evidentiary sources in the draft Guidelines is welcome. However, **the draft Guidelines appear to place particular emphasis on “pre-merger studies by independent external experts”.** Given that such reports do not arise in a vacuum, but instead are produced for a particular purpose and within a particular institutional context, most likely without examining the broader impacts on consumer welfare, longer term innovation incentives or complex dynamic impacts on competition, it is not clear why such reports should carry higher evidentiary weight. **It seems unnecessary and risky for the Guidelines to endorse any particular category of evidence too strongly.**

## Balancing benefits and harms

The draft Guidelines’ presentation of the *Theory of Benefit* and the taxonomies of efficiencies have understandably attracted significant attention. Ultimately, however, the practical relevance of these concepts will come down to how the Commission balances claimed benefits against competitive harm in the assessment of actual transactions.

The draft Guidelines address this issue in the final section of the efficiencies chapter.<sup>2</sup> The proposed approach is pragmatic: quantify and weigh benefits and harms against each other, *to the extent possible* depending on the nature of the comparison.

The draft distinguishes between two broad scenarios. First, for mergers where the benefits and harms are *symmetric*, in the sense that they concern the same parameter of competition and arise over a comparable timeframe, the draft Guidelines propose a direct comparison. This comparison should be based on a precise quantification if possible, or otherwise on an assessment of their relative magnitudes.

Second, for mergers where the benefits and harms are *asymmetric*, because they concern different parameters of competition or materialise over different time horizons, the draft Guidelines propose a comparison based on equivalent net present value terms to the extent possible. Where this approach is impracticable, the assessment would be based on relative magnitudes. For cases involving benefits and harms concerning strictly different dimensions of competition, the draft Guidelines refer only to a “*careful assessment*”.<sup>3</sup>

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<sup>2</sup> Draft Merger Guidelines, paras. 339-357.

<sup>3</sup> Draft Merger Guidelines, para. 349.

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At a high level, this approach is difficult to disagree with. Where reliable quantification is feasible, it is sensible for the Commission to directly compare benefits and harms. This logic is well-established in merger assessment already, including within some existing analytical tools. For example, *pricing pressure indices* and *indicative price rises* routinely incorporate efficiencies. Similarly, the balancing of impacts across different dimensions of competition is not new and is already recognised in the existing Guidelines.<sup>4</sup> The increasing emphasis on non-price dimensions of competition may, however, require greater reliance on empirical valuation techniques capable of comparing effects across different competitive parameters. For example, stated-preference methods such as conjoint analysis may help estimate consumers' valuation of changes in quality, innovation, sustainability, resilience, or product functionality, thereby facilitating comparisons between harms and benefits that would otherwise be difficult to assess.

Equally, where the Commission is able to weigh up relative magnitudes of benefits and harms based on robust evidence, it stands to reason that it should be confident in the outcomes without having to quantify them to an unrealistic degree of precision. In this sense, the draft Guidelines do not appear to depart radically from established practice or from basic economic reasoning.

However, the practical implications of this framework may depend less on the high-level principles than on the methodological details through which they are implemented. Questions relating to evidentiary standards, time horizons, discounting, and the treatment of dynamic or difficult-to-verify efficiencies are likely to prove decisive. Even relatively modest methodological choices may materially affect the balance between competitive harms and merger-specific benefits, particularly in transactions involving innovation, investment, or long-term market transformation.

For instance, on a net present value basis, a large but less certain future benefit should counterbalance a smaller but relatively certain immediate harm. However, a conservative choice of (high) discount rates may easily reverse the finding. Whether the Commission remains analytical rather than being overly cautious when it comes to uncertain future benefits will be key in practice.

Similarly, some sectors will be able to gather the evidence required and structure it more readily than others. For instance, for mobile network operators it has proven feasible, albeit with significant effort, to produce analysis robustly demonstrating the expected benefits to consumers. In contrast, cases involving digital ecosystems are likely to be more challenging, requiring an open mind on both sides on the evidence required and the framework for interrogating it.

That said, we consider it appropriate that the draft Guidelines leave the framework relatively open-ended. Dynamic efficiencies are often difficult to fit within a rigid framework. Indeed, the most beneficial efficiencies can also be the most disruptive, and therefore the least susceptible to standardised quantification. A flexible framework allows all stakeholders to develop methodologies suited to the specific facts of individual cases. By contrast, overly prescriptive guidance would risk locking the Commission into analytical approaches that may quickly become unsuitable in a context of evolving market realities and economic tools.

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*"By 'increased market power' is meant the ability of one or more firms to profitably increase prices, reduce output, choice or quality of goods and services, diminish innovation, or otherwise influence parameters of competition. In this notice, the expression 'increased prices' is often used as shorthand for these various ways in which a merger may result in competitive harm."* EC Horizontal Merger Guidelines, para. 8.

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## Measuring the process of innovation, not (just) its outcomes

In discussing the potential for mergers to harm innovation incentives, the draft Guidelines emphasise the importance of the *innovation process* itself, understood as distinct from *innovative outcomes*.

*The assessment of the loss of innovation competition is not focused on a specific future outcome, which may be uncertain, but on whether the merger significantly impedes the process of innovation rivalry, which has the potential to generate innovation and therefore has competitive value in the present.*<sup>5</sup>

We support this approach. Uncertainty and risk are inherent features of innovative activity, particularly in R&D-intensive industries such as digital markets, pharmaceuticals, biotechnology or advanced manufacturing. In these contexts, where the Commission will be asked to balance difficult arguments, it should not be incumbent on either the Commission or the merging parties to demonstrate the future outcomes of innovation activities with a high degree of certainty. Innovation competition derives value precisely from experimentation, parallel efforts, and the existence of competing technological pathways whose eventual success may be unknown *ex ante*.

At the same time, the practical application of this principle is likely to raise significant challenges. Consistent with the broader logic of the draft Guidelines, symmetry should apply to the assessment of both harms and benefits. If the Commission assesses anticompetitive effects by reference to their impact on the innovation process, then merger-specific efficiencies in the form of innovation benefits should be similarly evaluated based on their expected effects on innovation incentives, capabilities and rivalry, without requiring proof of specific future outcomes.

This in turn raises the difficult questions regarding evidence and quantification mentioned in the previous section. In practice, the Commission may need to compare reductions and enhancements of the innovation *process* that materialise over long time horizons, affect different dimensions of competition and cannot be easily translated into conventional pricing metrics. While the draft Guidelines contemplate quantification where feasible, and otherwise refer to a “*careful assessment*”, the operational content of this assessment remains open-ended.<sup>6</sup>

To illustrate this potential complication, let us consider a hypothetical merger between two firms that manufacture goods but also hold and develop substantial portfolios of standard essential patents (i.e., patents that are part of technology standards such as 5G, or Wi-Fi). The innovation process in such industries does not merely consist of parallel proprietary R&D pipelines but revolves around contributions in the standard-setting processes, where competitors are also collaborators jointly selecting the future technologies. On the harm side, it may be plausible that the merger leads to a reduction in innovation rivalry given the reduction in the number of competitors. On the benefit side, the merging parties may argue that combined R&D capacity enables closer collaboration between the R&D teams, leading to more ambitious contributions to the next generation of the standard and stronger incentives to innovate because the merged entity’s patents would cover a larger share of the standard. The potential harms and benefits would be difficult to quantify and compare because they are realised at different stages of a complex innovation process.

As discussed above, we do not advocate for the Commission to adopt a rigid framework for assessing innovation effects. However, the draft Merger Guidelines may benefit from a more explicit recognition of the inherent trade-offs. A framework that appropriately captures effects on the innovation process should tolerate a degree of uncertainty and probabilistic reasoning. Otherwise,

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<sup>5</sup> Draft Merger Guidelines, para. 175.

<sup>6</sup> Draft Merger Guidelines, para. 349.

there is a risk that innovation-related harms are recognised in principle on the basis of their impact on innovation rivalry, while innovation-related efficiencies continue, in practice, to face a materially higher evidentiary threshold because of the uncertainty surrounding future outcomes.

### **‘Same set of consumers’ principle**

Another challenge in assessing innovation-related efficiencies is that a substantial part of the benefits of innovation comes from knowledge spillovers and broader societal gains. This creates potential tensions between the draft Guidelines’ ambition to capture the innovation benefits of mergers and their proposed approach to assessing benefits and harms across customer groups and markets.

The draft Guidelines come close to ruling out any distributional assessments altogether. In order for efficiencies to offset the competitive harms, the draft requires that consumers affected by the merger are, taken as a whole, no worse off than under the counterfactual. This principle is set out with respect to direct efficiencies,<sup>7</sup> dynamic efficiencies,<sup>8</sup> collective benefits,<sup>9</sup> and the balancing of benefits and harms.<sup>10</sup>

As an exception, the draft Guidelines do present some flexibility regarding the distribution of benefits and harms within a given market.<sup>11</sup> However, even here, the text makes clear that any benefits must accrue to a significant portion of the customers harmed by the merger.

This cautious approach is understandable, given the difficulties in assessing distributional impacts and especially because the draft Guidelines seek to encourage the quantification of benefits and harms to the extent possible. Nevertheless, the existing trade-offs merit a more explicit recognition.

First, the restrictive treatment of distributional effects sits uneasily with the broader ambition of the draft Guidelines of accounting for potential benefits related to innovation, sustainability, security and resilience. These categories of benefits frequently exhibit public good characteristics, such that significant portions of the benefits accrue to society rather than exclusively to the specific market participants affected by the merger. A narrow scope risks undermining the very purpose of taking these goals into account.

Second, the most beneficial impacts of dynamic efficiencies arise from disruptive innovations. As the draft Guidelines also recognise, the main merger benefit may consist in the creation of entirely new products, technologies or even a completely new market.<sup>12</sup> An assessment predominantly focused on existing customers may miss out the most important benefits of the merger. More generally, disruptive innovations may alter market structures and demand patterns in ways that are difficult to predict. In such circumstances, the set of customers to whom the benefits accrue may not be clearly identifiable at the time of the merger assessment.

A stylised example illustrates the difficulty. Consider a merger between pharmaceutical companies that is expected to generate a modest price increase in certain existing therapeutic products, but which also materially increases the probability of successfully developing an effective treatment for early-stage cancer. The principal beneficiaries of the innovation may not coincide with the customers harmed by the price increase, particularly where the relevant products concern different

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<sup>7</sup> Draft Merger Guidelines, para. 315.

<sup>8</sup> Draft Merger Guidelines, para. 334.

<sup>9</sup> Draft Merger Guidelines, para. 322.

<sup>10</sup> Draft Merger Guidelines, paras. 352-357.

<sup>11</sup> Draft Merger Guidelines, para. 340.

<sup>12</sup> Draft Merger Guidelines, para. 329.

therapeutic areas or patient populations. Yet it would appear unduly restrictive to conclude that the potential innovation benefits are irrelevant to the competitive assessment because they do not accrue to the same identifiable group of consumers. The example highlights the tension between a strict ‘same consumers’ approach and the broader objective of taking dynamic innovation benefits meaningfully into account.

The draft Guidelines leave only some limited room for addressing these concerns. The proposed balancing exercise recognises that benefits and harms may arise in related markets where the groups of consumers benefitting from and harmed by the merger are substantially the same, such that “*substantially all*” consumers are fully compensated.<sup>13</sup> In practice, however, this is likely to represent a very demanding standard.

Similarly, the draft Guidelines appear to set a high threshold for sustainability and resilience benefits. The suggestion that such benefits are relevant only where the merger results in “*internalisation of consumption externalities*” by the same set of consumers harmed by the merger may limit the scope for these efficiencies to become relevant.<sup>14</sup> A strict reading could imply that sustainability and resilience benefits can only ever influence the outcome of the assessment if they resolve the underlying externality itself. There is a risk that such a demanding standard renders these efficiencies largely irrelevant in practice.

Clearly, the solution cannot be to open the gates to all types of consumer benefits accruing anywhere. This would risk turning the Commission’s merger assessment into an open-ended and unstructured debate over the spectrum of marginally affected markets and consumers, undermining predictability, administrability and legal certainty. A workable framework requires boundaries.

Our concern, however, is that the current draft Guidelines may unnecessarily constrain the Commission’s future assessments of merger benefits. It should be possible to preserve legal certainty and predictability, while still allowing flexibility for the assessment of innovation, sustainability and resilience efficiencies to evolve through case practice. Otherwise, there is a risk that these categories of efficiencies are recognised in principle but remain largely incapable of influencing merger outcomes in practice.

## Evidence on dynamic effects

The explicit discussion of evidentiary sources in the draft Guidelines is welcome. All stakeholders should benefit from greater clarity and more certainty around the types of evidence the Commission considers relevant. This may also help encourage earlier and more structured engagement on efficiencies between the merging parties and the Commission during the merger review process.

The draft Guidelines place emphasis on documentary evidence. This includes internal documents, but special mention is made of “*pre-merger studies by independent external experts on the type and size of efficiencies and on the extent to which consumers are likely to benefit from them*”, prepared “*in tempore non suspecto*”.<sup>15</sup> As others at Compass Lexecon have observed, documentary evidence can be valuable, but it does not substitute rigorous analysis.<sup>16</sup> All evidence, including documentary materials, must be interpreted within a coherent analytical framework for assessing the merging parties’ capabilities and incentives.

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<sup>13</sup> Draft Merger Guidelines, paras. 355-357.

<sup>14</sup> Draft Merger Guidelines, para. 322.

<sup>15</sup> Draft Merger Guidelines, para. 330.

<sup>16</sup> <https://www.compasslexecon.com/insights/publications/reflections-on-the-european-commissions-draft-merger-guidelines-where-should-we-focus>

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This remains the case even if the documentary evidence contains quantitative assessments of efficiencies. As discussed above, we agree with the general approach set out in the draft Guidelines of quantifying and comparing benefits and harms wherever possible. However, this should not lead to an undue prioritisation of numerical evidence over qualitative evidence, or to the uncritical acceptance of numerical estimates without a careful examination of the underlying assumptions and methodologies.

The draft Guidelines treatment of “*pre-merger studies by independent external experts*” may require further reflection. As currently drafted, the text could be read as signalling that such evidence should carry particular weight whenever available. We understand pre-merger studies to primarily refer to deal advisory studies on merger synergies and value creation, typically produced by consultancies or financial advisors for the management of the acquiring entity. While these sources do commonly produce estimates of merger synergies in monetary terms, these also do not arise in a vacuum. One must bear in mind the purpose and the context for such studies.

These studies may indeed contain estimates of merger synergies or value creation, and can offer a starting point for the assessment of merger efficiencies as part of competition authorities’ merger reviews. Third-party reports prepared for the management can highlight key considerations for the assessment and provide valuable insights on the idiosyncrasies of the industry and the merging parties.

However, these studies are produced for a particular purpose and within a particular institutional context. Typically, they are designed to assist management teams, boards or investors in placing a value on the transaction and to assess the expected financial returns. They are also prepared subject to specific professional standards and disclosure constraints, which may dictate that any assessments of synergies are based on suitably conservative estimates of the upsides of the merger validated by accounting data.

Accordingly, such studies may naturally place greater emphasis on shorter-term and more readily quantifiable merger synergies, such as procurement savings, elimination of shared fixed costs, or operational synergies. Conversely, they are unlikely to examine the broader impacts on consumer welfare, longer term innovation incentives or complex dynamic impacts on competition. Nor are they typically designed to assess whether efficiencies are merger-specific in the competition law sense, or whether they are likely to be passed through to consumers.

We understand the rationale behind the draft Guidelines’ interest in these forms of evidence. The apparent objective is to identify materials produced independently of the merger investigation itself, by parties with genuine commercial interest and therefore some degree of ‘skin in the game’. However, exactly because such reports are not prepared in the context of the Commission’s merger investigation, in most cases they are not directly responsive to the questions relevant for the assessment. As such, it would seem risky for the Guidelines to endorse these, or any other particular category of evidence too strongly. Different types of efficiencies are likely to require different forms of evidentiary support and it does not seem necessary to bind the Commission’s review of future mergers based on a strong endorsement of one type of evidence in particular.

Our suggestion is therefore not that documentary evidence should play a lesser role, but rather that the Guidelines should maintain greater neutrality regarding the relative weight of particular evidentiary sources. A more balanced formulation would reduce the risk of inadvertently privileging certain forms of measurable short-term efficiencies over more complex but potentially more significant dynamic benefits.

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## Recommendations

In sum, we recommend that the Guidelines:

1. consider the innovation process the same way when assessing efficiencies as when analysing the potential harm;
2. ensure that innovation, sustainability and resilience benefits can actually be taken into account, recognising their public good nature; and
3. maintain neutrality regarding the relative weight of particular evidentiary sources.