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# Necessity or Luxury Good?

## Household Energy Spending and Income in Britain 1991 - 2007

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### Abstract

The residential demand for energy is growing steadily and the trend is expected to continue for the foreseeable future. Household spending on energy services tends to increase with income. We explore household total spending on energy and on electricity and gas separately. We use an extensive British household panel data with more than 77,000 observations for the 1991-2007 period to explore the determinants of energy spending. We analyse income as a main driver of spending on energy and draw Engel spending curves for these. The lack of household level price data in liberalized retail energy markets is addressed by a new modelling approach to reflect within and between regional differences in energy prices. Also, long run changes in energy spending of households are approximated by exploring unit effects. The main results show the Engel spending curves are S-shaped. Income elasticities for energy spending are U-shaped and lower than unity, suggesting that energy services are a necessity for households. Moreover, the findings show that the income elasticity of energy spending is somewhat higher in the long run. Finally, we find a dynamic link between energy spending and income changes rather than a fixed budget threshold where basic needs are met. Hence, we suggest policy approaches that enable households to find their individual utility-maximizing energy spending levels.

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### 1. Introduction

The residential demand for energy is growing steadily in line with the societies' increasing economic affluence. As a result, the household sector accounts for a significant and increasing share of total energy use and the economic welfare associated with this. The trend is expected to continue for the foreseeable future. Household spending on energy services tends to increase with income. Therefore, enhancing our understanding of the determinants and characteristics of household energy demand and spending is useful as an economic study as well as for policy analysis.

A distinctive economic property of energy demand by households is that this demand is not driven by the utility from the use of energy per se. Rather, energy is an indispensable input for utilizing a wide range of services provided by many appliances and devices. Hence, demand for energy is derived by the need for services required for a range of necessities such as heating and cooking, to leisure activities of normal and luxury nature and, more recently, for production purposes such as working from home.

As household incomes gradually increase, the household demand for and thus spending on energy tends to increase. However, the level and drivers of energy demand can change with income levels. The effect of an income increase can more than compensate that of a price increase as seen in the case of increasing demand for oil despite

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15 price rises in the mid-2000s. The rising energy price in recent years and expected future price increases, e.g. to  
16 finance energy and environmental policy objectives, will have important demand and welfare implications for house-  
17 holds. While households with rising incomes may continue to increase their energy use and spending, those with low  
18 or stagnant incomes can be adversely affected by higher energy prices and expenditures. Waddams Price et al. (2007)  
19 show that households' perception of being fuel poor is linked to their actual fuel poverty.

20 A limited literature such as Baker et al. (1989), Yamasaki and Tominaga (1997), Liao and Chang (2002), Wu  
21 et al. (2004), Rehdanz (2007), Baker and Blundell (1991), Druckman and Jackson (2008), and Meier and Rehdanz  
22 (2008) have analysed aspects of household energy demand and spending. However, there is a need for further detailed  
23 studies of the underlying dynamics of household spending on energy in particular with respect to income changes  
24 and energy price differences among them. The drivers and determinants of demand for energy include a varied set of  
25 socio-economic factors ranging from income, through housing characteristics and family size to price responsiveness.

26 This paper differs in few respects from previous studies that use household production frameworks (Baker et al.,  
27 1989) or a discrete continuous approach (e.g. Baker and Blundell, 1991). The use of household micro data often  
28 requires the researcher to control for the effect of unobserved heterogeneity. We use an extensive real panel data of  
29 British household surveys that allows in-depth analyses of energy spending and income of the same households over  
30 time and control for the individual effects. This enables us to use fixed effects models to analyse the dynamics at  
31 the individual level while other studies have used pooled cross section data (Baker and Blundell, 1991; Baker et al.,  
32 1989; and Rehdanz, 2007). We take into account the temporal variations in energy spending and its time-varying  
33 determinants to capture the fixed effects as well as the socio-economic characteristics that affect energy spending.  
34 While previous studies have used cross-sectional data to analyse long-run responses to changes in income and price,  
35 the present paper also focuses on short-run responses to these. Moreover, Blundell et al. (2007) explore Engel curves  
36 for British family expenditure using semi-nonparametric techniques assuming that total budget is endogenous and  
37 households choose whether to spend their budget on goods or save instead. However, the choice between consumption  
38 and saving can be invariant over time. Using fixed effects models allows us to take a possible endogeneity into account.

39 In this paper, we analyse overall energy spending, as well as gas and electricity spending separately. The study  
40 covers the post-liberalisation period of the electricity and gas sectors in the UK after these transformed into market-  
41 oriented sectors. We focus on two aspects of household energy spending. First, we model the link between energy  
42 spending and income while controlling for a set of important variables. Some evidence suggests that energy spending  
43 tends to increase with income though less than proportionately (OECD, 2008) implying that, energy services may be  
44 regarded as a necessity good and have an income elasticity greater than zero and smaller than unity. We derive the  
45 Engel curves for energy spending holding other variables constant and provide evidence of a monotonic relationship  
46 between energy spending and income that suggests changes in the uses of energy as income increases. We show how  
47 energy spending changes as income (and prices) rises.

48 Second, we model the measurement errors in energy prices. Data on energy prices is only available as time  
49 series. This poses a challenge for empirical applications in liberalized energy markets where different households can  
50 be faced with differing prices depending on payment methods and region of living. Hence, the assumption that all  
51 households face identical fuel prices every year does not strictly hold. We address the lack of information in prices by  
52 modelling the difference between individual (i.e. household) and national prices as a function of differences in income  
53 with respect to households' own regions as well as the differences between regions. This approach aims to take into  
54 account that payment methods and location can yield different fuel prices for households with different income levels.

55 We find that the link between energy spending and income cannot be explained by simply describing energy as  
56 a necessity. Energy spending can increase with income, but at an uneven rate. Engel curves for energy spending  
57 are neither linear nor do they continuously increase or decrease. Rather, they exhibit an S-curved shape along which  
58 households energy spending increases, stagnates, or declines with income. We then show that income elasticity of  
59 energy spending changes with income. The results indicate that our modelling approach to overcome the lack of indi-  
60 vidual price data is effective. Also, the building types have significant impacts on energy spending. Moreover, energy  
61 spending increases in the number of children but decreases in the average household age. In addition, households with  
62 no access to gas tend to pay more for electricity. Finally, the second stage estimations indicate that household energy  
63 spending responds more strongly to changes in income in the long run.

64 The next section gives a review of the relevant literature. Section 3 describes the methodology used in the pa-  
65 per. Section 4 describes the data used and Section 5 presents and discusses the results of the empirical analysis for  
66 electricity, gas, and energy. Section 6 is the conclusions.

## 67 2. PREVIOUS STUDIES

68 The study of the link between income and household energy spending can be traced to the late 1800s. Engel  
69 (1895) analysed costs of living among Belgian working families. He stated that the welfare of a society depends on  
70 the extent to which its needs can be satisfied. Engel also argued that the income of a population must, at least, be high  
71 enough to cover its needs and thus its costs of living. He grouped these needs into different categories and suggested  
72 that not all needs are equal in terms of necessity and some goods and needs are important for physical survival, i.e.  
73 food, clothes, homes, health care, heating, and lighting. According to Engel, the level of social welfare depends on  
74 the ratio of spending on necessary goods over the budget remaining for spending on other goods. For spending on  
75 heating and lighting, Engel found that this accounted for 5% of total cost of living of a Belgian household.

76 Residential energy use has been the subject of other early studies and econometric analyses prior to the oil price  
77 shocks in the 1970s. In an early work Houthakker (1951) examined British urban electricity consumption. A number  
78 of other studies have since been undertaken. Madlener (1996) presents a detailed survey of the early literature (1951-  
79 1996) focused on studies of demand for electricity. The survey points to the difficulty of comparing the findings of  
80 many of the studies as they use a range of approaches and techniques.

81 In a study aimed at developing budget standards, Bradshaw et al. (1987) present the ‘S-curve analysis’ as a statisti-  
82 cal technique to identify expenditure levels that could serve as such standards. They discuss the S-curve approach as a  
83 mean to detect inflection points where the expenditure allocated to a necessity good such as energy, food, and clothing  
84 turns. In other words, as household income increases, spending on necessity goods increases (less than proportional)  
85 until an inflection point is reached beyond which spending flattens (or even declines) before it increases again. The  
86 inflection points can shed some light on the nature of the consumption of a good as a necessity, normal, or for luxury  
87 use.

88 Whereas some empirical studies that followed Engel (1895) found considerable nonlinearities in Engel curves,  
89 recent studies in Bierens and Pott-Buter (1990) and Lewbel (1991) have advocated using nonparametric regression  
90 methods. Some studies control for measurement errors and other covariates, including Hausman et al. (1995) and  
91 Banks et al. (1997) who find that Engel curves for some goods display considerable curvature, including quadratics  
92 or S shapes.

93 Yatchew (2003) adopts a semi-parametric approach to estimate Engel curves for food using South African data.  
94 The study shows that food spending decreases in total expenditure. He also estimates equivalent scales for different  
95 family compositions or sizes in order to examine whether or not equivalence scales vary with income levels.<sup>2</sup> The  
96 results show that a couple with two children is equally well off relative to a single person household at an equivalent  
97 scale of 2.16. A parsimonious specification of equivalent scales produced lower standard errors than a pairwise  
98 comparison of Engel curves.

99 Blundell et al. (2007) explore Engel curve systems for the British Family Expenditure Survey using semi-  
100 nonparametric techniques. The study assumes that the total budget is endogenous and households choose whether  
101 to spend their budget on goods or save instead. However, the choice between consumption and saving is likely to be  
102 invariant over time. Using a fixed effects model as in our paper allows us to take this endogeneity into account. The  
103 study finds some evidence of an S-shaped relationship between income and consumption of different goods. They  
104 also explore the budget share spent on fuel for households with and without children. The Engel curve for fuel ex-  
105 hibits an almost continuously downward slope. Specifics of fuel consumption and what fuel actually stands for are  
106 not discussed in detail.

107 Baker et al. (1989) develop a two stage budgeting model of fuel consumption and explore households’ response  
108 to price changes and response by different age groups and birth cohorts. The model assumes that, in the first stage,  
109 households allocate their income as budget shares to fuel consumption and non-fuel goods. In the second step,  
110 households make within-fuel decisions and allocate their fuel budget among different fuels. They control for some  
111 socio-economic characteristics for three income groups: lower, middle and top income deciles. The results indicate  
112 that gas and electricity are necessities and for some households, electricity is an inferior good.

<sup>2</sup>Equivalence scales model the dependence of utility functions on family size and use this dependence to compare welfare across households, assuming that a large family with a high income is as well off as a smaller family with a lower income if both families have demands that are similar in some way, such as equal food budget shares or equal expenditures on adult goods such as alcohol.

113 Nesbakken (1999) analyses household energy consumption in Norway using a discrete choice model. The study  
 114 explores the choice of heating equipment and models the residential energy consumption as being conditioned by the  
 115 equipment. Income and energy prices are analysed for households with incomes below and above the mean level. The  
 116 results show that short run income elasticities are equal to unity and hardly depend on income group. In the long run,  
 117 low-income households have an elasticity of 0.18 and high income households have an elasticity of 0.22. Households  
 118 in the high-income group had a higher price elasticity of energy consumption than low-income households. The higher  
 119 price responsiveness of high-income households is explained by their high energy consumption and comparably lower  
 120 marginal utility from energy consumption. In contrast, low-income households face larger loss of utility if energy  
 121 prices increase and thus do not reduce their energy consumption to the same extent as high-income households.

122 Roberts (2008) focuses on low-income households in Britain and shows that some have a relatively high energy use  
 123 and this is, in particular, the case for many elderly people who live in large and thermally inefficient homes. Druckman  
 124 and Jackson (2008) analyse UK household energy use at national and local level using data from the Expenditure and  
 125 Food Survey 2004-2005. The study uses the Local Area Resource Analysis (LARA) model to estimate household  
 126 energy use in specific neighbourhoods. Socio-economic and demographic characteristics of households are viewed  
 127 as important drivers and the findings show a strong link between energy consumption, income, and carbon emissions.  
 128 Waddams Price et al. (2007) examine fuel poverty and its official definition in the UK. Using survey data of low  
 129 income households the study examines the relationship between the objective fuel poverty measure and the attitude  
 130 of households including their belief in the extent to which they can afford sufficient energy. The study shows that the  
 131 households' perception of being fuel poor is linked to their actual fuel poverty.

132 Navajas (2009) explores the correlation between income and the natural gas consumption among Argentinian  
 133 households and shows that at low prices, income only has a weak impact on consumption. At the same time, household  
 134 characteristics such as the size of households are stronger drivers of gas consumption. In addition, some studies have  
 135 explored other socio-economic and technical factors and their impact on energy usage and spending, for example,  
 136 ageing households (Yamasaki and Tominaga, 1997 and Liao and Chang, 2002), tenancy of a property (Rehdanz, 2007  
 137 and Meier and Rehdanz, 2008), or technical characteristics of buildings (Leth-Petersen and Togeby, 2001).

138 The UK household energy consumption increased by 12% between 1990 and 2006 mainly due to an increase in the  
 139 number of households and a trend towards smaller households. Currently, the domestic sector accounts for about 30%  
 140 of UK's total energy consumption (Utley and Shorrocks, 2008). In recent years the energy policy debate is increasingly  
 141 influenced by climate change and renewable energy objectives both of which highlight the importance of improving  
 142 energy efficiency (BERR, 2008; DTL, 2007). Residential energy usage has important social welfare dimensions that  
 143 need to be taken into account in the current debate.

144 In the UK, households that spend more than 10% of their income on energy are defined as being fuel poor. These  
 145 households are likely to face difficulty in warming their homes adequately. In addition, a comparatively lower share  
 146 of their income can be spent on other goods (Defra and BERR, 2008). The climate change concerns and renewable  
 147 energy policies will lead to higher energy prices. While the energy efficiency of the domestic building stock has  
 148 improved considerably, the potential for further improvement remains high (DEFRA, 2009; Utley and Shorrocks,  
 149 2008). This is also discussed in the Hills (2012) report that argues that instead of focusing on percentage income  
 150 thresholds as an indicator for fuel poverty, individual households should be explored instead. According to the report  
 151 many fuel poor households are on low income and live in houses that can only be warmed at very high costs.

### 152 3. METHODOLOGY

153 As noted previously, some studies that have explored the link between energy usage and income have found  
 154 positive income elasticities lower than unity. All studies tend to estimate a single value for income elasticity for  
 155 a whole sample or some sub-groups. However, the dynamics behind the link can be better analysed using a panel  
 156 micro-dataset while controlling for other socio-economic variables. In this paper we explore the linkage between  
 157 household energy spending and income as well as the differences among fuels.<sup>3</sup>

158 Following Bradshaw et al. (1987) and Jamasb and Meier (2010), we derive a plot of average energy spending  
 159 against average income levels in Figure 1 for the period of study (1991-2007). As can be seen from the figure, energy

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<sup>3</sup>We do not explore the linkages between spending on different fuels and hence do not use spending shares as in Baker et al. (1989).

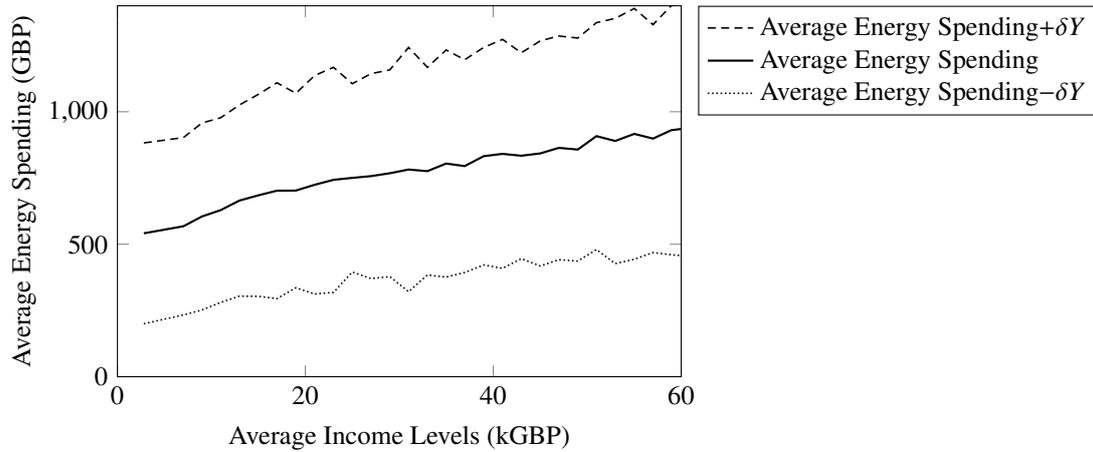


Figure 1: Average energy spending levels and standard deviation for average gross household real income levels

160 spending tends to continuously increase in income even though at certain income levels energy spending stagnates (or  
 161 even declines) as income continues to increase. However, the standard deviations show that this link is rather complex  
 162 and other variables can have an impact on energy spending at differing income levels. In order to understand this link  
 163 we use econometric models that enable us to control for the impact of other factors and thus draw a more differentiated  
 164 picture.

165 We examine total energy expenditures as well as spending on electricity and gas, separately using an econometric  
 166 analysis of a large sample of households in Great Britain. We model third-order functions of income in order to  
 167 examine spending response to income changes. Understanding the dynamics of how energy spending changes with  
 168 income is helpful for designing targeted policy measures. Further, we address measurement errors in fuel prices as  
 169 households in a liberalised retail markets face different energy prices for which data is not available.

170 We specify a set of econometric models of income, fuel prices and other determinants of energy spending in order  
 171 to draw Engel curves for energy spending as well as for spending on electricity and natural gas separately. We utilize  
 172 the panel nature of the data in order to control for the effect of unobservable effects, in our case, individual household  
 173 characteristics, that influence their energy spending. Our energy spending models can be generalised as in Equation  
 174 (1).

$$\ln E_{it} = \beta X'_{it} + \nu_i + \epsilon_{it} \quad (1)$$

175 where  $\ln E_{it}$  is overall energy, electricity, or natural gas spending in logs, subscript  $i = 1, \dots, N$  stands for household,  
 176 subscript  $t$  is time,  $X_{it}$  is a vector of explanatory variables,  $\nu_i$  captures cross-sectional heterogeneity in our dataset, and  
 177  $\epsilon_{it}$  is the conventional noise term.

178 Some studies have used different estimators with panel data models (e.g. Sherron and Allen, 2000; Farsi and  
 179 Filippini, 2004; Hausman and Taylor, 1981) where the debate on model specification has mainly focused on the fixed  
 180 versus the random effects approaches. Random effects (RE) models capture the effect of individual differences but  
 181 these are treated as random as opposed to parameters estimated using the fixed effects approach (FE). The random  
 182 effects models assume that the time-invariant household characteristics are randomly distributed across households  
 183 but they are uncorrelated with the explanatory variables. If this assumption holds, the random effects approach leads  
 184 to more efficient estimation results. However, if the assumption is incorrect, it leads to biased results.<sup>4</sup>

185 We test whether the random effects and the explanatory variables are correlated using the Hausman test of the hy-  
 186 pothesis that differences in coefficients are not systematic. The test calculates the differences between the coefficients  
 187 of fixed effects and random effects models and examines if the coefficients vary systematically. The null hypothesis  
 188 is the lack of correlation and hence that the RE coefficients are estimated consistently. In our analysis the Hausman

<sup>4</sup>See e.g. Hausman (1978), Owusu-Gyaopong (1986), Baltagi et al. (2003), and Hausman and Taylor (1981).

189 test rejected the random effects model. Hence, we use the fixed effects approach to estimate our models. The results  
190 of the Hausman tests are presented in Section 6.

191 Also, as the household effects are correlated with the explanatory variables<sup>5</sup>, we can use the traditional fixed effects  
192 estimator to address the endogeneity problem. As this estimator ignores the cross-sectional (i.e. between) information  
193 among households and only takes into account the temporal (i.e. within) dimension of our data, it is not possible to  
194 control for time-invariant variables. However, the inability to control for time invariant variables is not hindering our  
195 analysis as the variables used in our models vary over time.<sup>6</sup> An extension of the Hausman test is the Sargan-Hansen  
196 test. A cluster-robust version of this test is robust to heteroskedasticity as well as within-group correlation (Schaffer  
197 and Stillman, 2010).<sup>7</sup>

198 As mentioned, the models used in our analysis have two important features. First, we use third-order functions of  
199 income in order to identify inflection points in “pure” Engel energy spending curves. Hence, our model in equation  
200 (1) can be rewritten as:

$$\ln E_{it} = \ln f(Y_{it}, \alpha) + \beta X'_{it} + \nu_i + \epsilon_{it} \quad (2)$$

201 where  $Y_{it}$  is annual household real income, and  $f(\cdot)$  is a third-order function of income and can be interpreted as a  
202 “pure” Engel energy spending curve. We use the following cubic functional form for  $f(\cdot)$ :

$$\ln f(Y_{it}) = \alpha_1 \ln Y_{it} + \frac{\alpha_2}{2} (\ln Y_{it})^2 + \frac{\alpha_3}{3} (\ln Y_{it})^3 \quad (3)$$

203 The second aspect concerns the energy prices. Disaggregated average energy prices are available on a regional level  
204 and for the main three different payment methods from the Department of Energy and Climate Change (DECC).<sup>8</sup>  
205 However, this data is only available for the 1998-2007 period and thus restricts the number of observations that can be  
206 analyzed.<sup>9</sup> Hence, we use both the annual price data for the UK reported in IEA (2005; 2007) as well as the between  
207 and within regional differences in income to control for the unobserved differences in prices among households. Our  
208 results support this approach.<sup>10</sup>

209 In liberalised retail electricity markets, the actual prices paid by individual households can vary somewhat around  
210 average annual prices reported by official statistics. Indeed, estimates of annual domestic bills show that unit prices  
211 do not only vary among the regions but they also vary with the choice of supplier and contract type. Also, some  
212 consumers can pay more than others if they do not take advantage of the competitive retail market. Although many  
213 consumers switch supplier, some only switch from one former monopoly to another former monopoly supplier. Nearly  
214 70% of consumers still have their energy supplied from a former monopoly supplier (Ofgem, 2008).

215 Prices can also differ according to payment methods such as such as credit, direct debit, or prepayment. Evidence  
216 suggests that customers on direct debit payment have the lowest unit prices (DECC, 2011). Households on low  
217 incomes make up a large share of pre-payment users. Although these consumers generally pay higher unit prices,  
218 many of them choose this method in order to better manage their budget. In addition, price premiums for pre-payment  
219 meters can vary according to geographic region and the amount of energy consumed. Moreover, consumers on

<sup>5</sup>The household effects might, for example, cover the environmental attitude of household members. An environmental-friendly attitude could lead to more efficient energy usage due to, for example, differences in education levels which also affect income levels.

<sup>6</sup>While fixed effects models make weak assumptions on the unit-specific effects, in that they can be arbitrarily correlated with the regressors, and have the virtue of being relatively easy to implement, they produce imprecise estimates when the data contains variables with relatively low within variance.

<sup>7</sup>The test is run using the ‘xtoverid’ Stata command by Schaffer and Stillman (2010). Using the cluster option, the test is robust to heteroskedasticity and within-group correlation. The test shows whether the extra orthogonality conditions used in the random effects estimator are valid, i.e. both ‘FE’ and ‘RE’ estimators would be efficient. If the null hypothesis is rejected, the random effects estimator is inconsistent.

<sup>8</sup>See [http://www.decc.gov.uk/en/content/cms/statistics/energy\\_stats/prices/prices.aspx](http://www.decc.gov.uk/en/content/cms/statistics/energy_stats/prices/prices.aspx).

<sup>9</sup>Issues arising in this context are discussed in Section 5.

<sup>10</sup>Regardless of the data set, our *aggregated* price variables are crude proxies of the real average prices paid by *individual* households. This obviously prevents computing energy quantities and estimating a pure energy demand function. It is worth mentioning that average prices paid by individual households will vary with quantities consumed as tariffs are decreasing in quantities. The lack of individual information on prices does not allow us to address this issue explicitly. However, our empirical model is able to capture this issue indirectly. Households on higher incomes tend to use cheaper per unit payment methods than poorer households. Thus individual average prices (which are not observed by the researcher) will be correlated with income. As explained later on, we address this endogeneity problem by adding two variables measuring within and between regional differences in income. At the same time, since individual average prices are unobserved, some of the variation will be captured by the fixed effects in our model.

single-fuel arrangements pay higher margins due to the lack of competition. In Scotland and Wales markets are more concentrated and a large number of rural consumers is not connected to the gas grid and pays higher premiums on their electricity prices (Ofgem, 2008).

There are three main drivers of differences in prices among households: market concentration, the payment method, and single fuel arrangements. In order to control for unobserved differences in prices among households we incorporate proxies for these drivers in our model. First, there are variations in energy prices across the regions due to differences in market structures. We proxy the regional differences in prices by using the differences in income levels between different regions. The intuition behind this is that the more densely populated regions are also regions with higher Gross Disposable Household Income (GDHI). At the same time, in these regions, energy markets tend to be less concentrated, therefore there is a higher likelihood of consumers switching suppliers and hence price margins being lower. For example, London has the highest GDHI per head while Scotland and Wales have the lowest GDHI (ONS, 2009a) and also have the most concentrated energy markets in Great Britain.

Second, we control for the within-region differences in energy prices due to payment methods by including a variable that measures the differences in income levels within individual regions. As mentioned, households on very low incomes make up the largest share of the prepayment consumers and pay higher prices. For example, London has the highest GDHI among all GB-regions but it also has the most unequal distribution of incomes. A large number of households in London lives on very low incomes (ONS, 2009a). In order to address this issue, we model the differences in energy prices within the regions based on differences in income levels within regions. Third, households on single fuel arrangements who are not connected to the gas network tend to pay higher electricity prices (Ofgem, 2008). We control for this by assuming that households with no gas spending do not have access to gas.

If we remove fuel prices from the set of explanatory variables, the model to be estimated can be written again as:

$$\ln E_{it} = \ln f(Y_{it}, \alpha) + \beta X'_{it} + \gamma \ln P_{it} + \nu_i + \epsilon_{it} \quad (4)$$

where  $P_{it}$  is the actual price paid by an individual household  $i$  in year  $t$ . It could be either the gas or electricity price or a vector of the two prices. Since actual prices paid by individual households are not available, we use the annual price data for the UK as reported in IEA (2005; 2007). As data on energy prices is only available as time series, we replace  $P_{it}$  by the average annual price,  $P_t$ , reported by official price statistics, which is common to all households. This implies that measurement errors in individual fuel prices occur and it can be modelled as:

$$\ln P_{it} = \ln \left( \frac{P_{it}}{P_{Rt}} \right) + \ln \left( \frac{P_{Rt}}{P_t} \right) + \ln P_t \quad (5)$$

where  $P_{Rt}$  is the average price in the household's region  $R$ , which is common to all household in region  $R$ . Hence, if we replace  $\ln P_{it}$  in Equation (4) with the expression in (5), we obtain:

$$\ln E_{it} = \ln f(Y_{it}, \alpha) + \beta X'_{it} + \gamma \left[ \ln \left( \frac{P_{it}}{P_{Rt}} \right) + \ln \left( \frac{P_{Rt}}{P_t} \right) + \ln P_t \right] + \nu_i + \epsilon_{it} \quad (6a)$$

or,

$$\ln E_{it} = \ln f(Y_{it}, \alpha) + \beta X'_{it} + \gamma \ln P_t + \gamma \left[ \ln \left( \frac{P_{it}}{P_{Rt}} \right) + \ln \left( \frac{P_{Rt}}{P_t} \right) \right] + \nu_i + \epsilon_{it} \quad (6b)$$

where the term in brackets represents the measurement errors in individual energy prices, i.e.  $\ln P_{it} - \ln P_t$ . From Equation (5), the measurement errors in individual prices are decomposed into *within region* differences (i.e. the gap between the individual price and the average price in household's region) and *between region* differences (i.e. the gap between the average price in household's region and national energy prices). Both gaps within and between region differences are not observed, hence we proxy them using differences in income.<sup>11</sup>

<sup>11</sup>An alternative approach is to treat the term in brackets as an omitted variable and leave it in the error term. As prices are measured with error, endogeneity problems might arise (see e.g., Wooldridge 2002), and an instrumental variable estimator should be used to consistently estimate the main coefficients of the energy spending function. However, as pointed out by Greene (2005), identifying appropriate instrumental variables in this setting is difficult. Unlike in other empirical exercises, and as discussed earlier, with our approach it is easier to find proxies for the measurement error term,  $\ln P_{it} - \ln P_t$ , than in an IV procedure. Using the latter approach, good instruments are variables that are *not* correlated with  $\ln P_{it} - \ln P_t$ , but highly correlated with the observed price,  $\ln P_t$ .

254 In particular, we model the errors in energy prices as follows:

$$\ln P_{it} - \ln P_t = \delta_W \ln \left( \frac{y_{it}}{y_{Rt}} \right) + \delta_B \ln \left( \frac{y_{Rt}}{y_t} \right) + \delta_A n g_{it} \quad (7)$$

255 In addition, we include a dummy variable for access to gas  $n g_{it}$  in order to capture the differences in prices due to lack  
256 of gas connection. If we insert (7) into (6b), the final model to be estimated is as in Equation (8):

$$\ln E_{it} = \ln f(Y_{it}, \alpha) + \beta X'_{it} + \gamma \ln P_t + \theta_W \ln \left( \frac{y_{it}}{y_{Rt}} \right) + \theta_B \ln \left( \frac{y_{Rt}}{y_t} \right) + \delta_A n g_{it} + \nu_i + \epsilon_{it} \quad (8)$$

257 where  $\theta_W = \gamma \delta_W$ ,  $\theta_B = \gamma \delta_B$ , and  $\delta_A = \gamma \delta_A$ . We estimate the effect of various independent variables on total energy  
258 spending,  $E_{it}$ , as well as the spending on electricity ( $El_{it}$ ) and natural gas ( $G_{it}$ ). We distinguish among the two energy  
259 sources as they are mainly used for different purposes. While electricity can be used for all electric appliances, gas is  
260 mainly used for heating and hot water supply. Total energy spending covers both effects and also contains spending  
261 on oil which is also used for heating.

262 Based on Equation (8) our models for total energy spending with and without controlling for differences in indi-  
263 vidual and national prices are given in Equations (9) and (10).

$$\ln E_{it} = \ln f(Y_{it}, \alpha) + \beta X'_{it} + \gamma \ln P_{gt} + \gamma \ln P_{et} + \theta_W \ln \left( \frac{y_{it}}{y_{Rt}} \right) + \theta_B \ln \left( \frac{y_{Rt}}{y_t} \right) + \delta_A n g_{it} + \nu_i + \epsilon_{it} \quad (9)$$

$$\ln E_{it} = \ln f(Y_{it}, \alpha) + \beta X'_{it} + \gamma \ln P_{gt} + \gamma \ln P_{et} + \delta_A n g_{it} + \nu_i + \epsilon_{it} \quad (10)$$

265 The difference between those two equations is in the implementation of the measurement errors in individual energy  
266 prices ( $\ln P_{it} - \ln P_t$ ). These are captured in (9) but omitted in (10). A comparison of the estimation results of the  
267 two models will reveal the differences in their explanatory powers. Note that in equation (10), we retain the no gas  
268 (NOGAS) dummy in both models because it is not related to specific regions but refers, to some extent, to the general  
269 rural vs. urban divide which is different from regional differences across the country. This can be related to the urban  
270 heat island effect which implies that heating loads of buildings tend to be lower in cities where a larger amount of  
271 buildings is built on a smaller area as opposed to rural areas (Kolokotroni et al., 2012). At the same time, the number  
272 of flats with lower levels of heat loss is higher in urban areas while there are more detached houses in rural areas.

273 Furthermore,  $P_{gt}$  and  $P_{et}$  denote the annual gas and electricity prices, respectively. The vector of explanatory  
274 variables  $X_{it}$  reflects the socio-economic and building characteristics at the household level. The socio-economic  
275 variables are the average household age (AVERAGE AGE), the number of children (CHILDREN) as well as a dummy  
276 variable that is equal to one if a households owns the property (OWNED). Building characteristics cover differences  
277 in building types. These are dummies for detached (DETACHED) and semi-detached (SDETACHED) houses, end-  
278 terraced (END-TERRACED) and terraced (TERRACED) houses and flats (FLATS). The household specific fixed  
279 effects are given with  $\nu_i$ .<sup>12</sup>

280 We hypothesise that spending levels increase in fuel prices but decrease in within and between regional differences  
281 in income levels. For the explanatory variables we hypothesize that energy spending increases in average household  
282 age with older household members spending more time at home. We also expect energy spending to be increasing in  
283 the number of children. First, children tend to spent more time at home than a full-time working adult and second;  
284 the number of appliances tends to be higher for households with more children. When households own their home  
285 they have a stronger incentive to invest in the energy efficiency but they also tend to live to larger extents in detached  
286 and semi-detached houses and thus experience higher heat loss levels than renters who mainly live in flats.<sup>13</sup> For  
287 the building types we assume that flats have the lowest spending levels and detached houses the highest levels of all  
288 building types.

289 Regarding specific fuels, we estimate the following models for electricity and gas, respectively:

$$\ln El_{it} = \ln f(Y_{it}, \alpha) + \beta X'_{it} + \gamma \ln P_{et} + \theta_W \ln \left( \frac{y_{it}}{y_{Rt}} \right) + \theta_B \ln \left( \frac{y_{Rt}}{y_t} \right) + \delta_A n g_{it} + \nu_i + \epsilon_{it} \quad (11)$$

<sup>12</sup>Using the Stata 'xtreg, fe' command, we assume that the average value of the fixed effects of all households is equal to zero.

<sup>13</sup>See Meier and Rehdanz (2010) for a discussion.

290

$$\ln G_{it} = \ln f(Y_{it}, \alpha) + \beta X'_{it} + \gamma \ln P_{gt} + \theta_W \ln \left( \frac{y_{it}}{y_{Rt}} \right) + \theta_B \ln \left( \frac{y_{Rt}}{y_t} \right) + \nu_i + \epsilon_{it} \quad (12)$$

291 Here  $El_{it}$  (11) and  $G_{it}$  (12) represent the households' annual electricity and gas spending, respectively. For the indi-  
 292 vidual fuels we only control for the respective fuel price<sup>14</sup> and omit the no-gas-dummy in (12). As noted earlier, the  
 293 parameters of the above models can be interpreted as short-run responses in energy expenditures to changes in income  
 294 and/or other explanatory variables. In particular, as from one year to another we do not expect major technological  
 295 adjustments<sup>15</sup>, the estimated vector of parameters  $\alpha$  is mostly related to income variations over time, given the stock of  
 296 appliances used. However, since the mix of appliances is related to income, we also expect a different effect of income  
 297 on energy expenditures for different levels of income. The short-term approach to modelling demand/expenditure has  
 298 been used in other studies reviewed earlier - e.g. in Meier and Rehdanz (2010), Rehdanz (2007), and Leth-Petersen  
 299 and Togeby (2001).

300 We use a log-linear functional form, i.e. we take the natural logarithm of energy expenditures, energy prices,  
 301 annual household income and the number of children. Also, we use the Consumer Price Index (CPI) of the UK  
 302 Office for National Statistics (ONS) with 2005=100 (ONS, 2009b) to adjust all monetary values to overall price  
 303 developments. Thus, the dependent variables are the ln of household annual electricity, gas, and energy expenditures  
 in 2005 prices.

Variable	Obs	Mean	Std. Dev.	Min	Max
ENERGY*	77,116	723.81	377.21	1.07	11,915.57
ELECTRICITY*	77,116	368.7	224.14	1.05	8,592.91
GAS*	67,941	375.62	227.07	0.96	11,171.38
INCOME*	77,116	26,293	21,339	76	764,801
INCOME SQ	77,116	49.35	7.52	9.35	91.77
INCOME TR	77,116	329.71	74.26	26.95	828.79
GAS PRICE*	77,116	243.42	42.83	207.89	359.71
ELECTRICITY PRICE*	77,116	0.08	0.01	0.07	0.1
INCOME BETWEEN	77,116	0	0.13	-0.42	1.4
INCOME WITHIN	77,116	-0.24	0.75	-5.93	3.4
NO GAS	77,116	0.12	0.32	0	1
AVERAGE AGE	77,116	43.54	20.87	5.25	99
CHILDREN	77,116	0.57	0.96	0	9
OWNED	77,116	0.73	0.45	0	1
DETACHED	77,116	0.22	0.42	0	1
SDETACHED	77,116	0.33	0.47	0	1
END-TERRACED	77,116	0.08	0.27	0	1
TERRACED	77,116	0.2	0.4	0	1
FLAT	77,116	0.17	0.37	0	1

\* Energy, electricity and gas spending and INCOME in GBP per year. Monetary values are in real terms 2005 prices. Gas prices are in GBP per 10<sup>7</sup> kilocalories GCV. Electricity prices are in GBP per kWh.

Table 1: Summary statistics of variables

304

<sup>14</sup>As our dependent variables are spending levels rather than consumption levels the interpretation of cross price effects is not as straightforward. We expect electricity and gas in the short run to be mainly complementary and thus an increase in the price of electricity would reduce gas consumption, if both fuels are available.

<sup>15</sup>I.e. the FE estimator only takes into account the within-household annual (short-term) variations.

#### 305 4. Data

306 The data used in this study is based on the British Household Panel Survey (BHPS). The dataset consists of  
 307 an unbalanced panel of more than 5,000 households, over a 17 year period from 1991 to 2007. As part of the  
 308 survey approximately 10,000 individuals have been re-interviewed annually. The primary objective of the survey is  
 309 to enhance understanding of social and economic change at individual and household level in Britain. The BHPS  
 310 covers the major topics of household organization, labour market, income, and wealth as well as housing etc. The  
 311 survey is intended to be nationally representative. However, this may not be necessarily the case along the dimension  
 312 of household income. The selection of households for the survey is based on a clustered stratified sample of addresses  
 313 in Great Britain; and the main selection criteria are age, employment, and retirement.

314 The BHPS survey contains data on annual household spending on different fuels, information on buildings (build-  
 315 ing type, ownership of property), and regional location of households. It is also possible to differentiate between  
 316 households living in urban and rural areas. In addition, the data includes annual household income as well as several  
 317 household characteristics such as size, age of members, employment status. Table 1 presents the summary statistics  
 318 for the data and the models used in this paper. Except for the dummy variables we use the natural logarithm of all  
 319 explanatory variables in our analysis.

320 The household energy spending levels depend, among other factors, on energy price movements. In order to  
 321 capture the effect of price developments we match the BHPS with annual data on average yearly UK energy prices for  
 322 gas and electricity. The data is drawn from the IEA (2005) and IEA (2007).<sup>16</sup> The development of gas and electricity  
 323 prices has been fairly similar as the UK electricity prices have largely followed those of natural gas reflecting the rapid  
 324 increase in the share of electricity generated from gas and its role as the market price setter in the post liberalisation  
 325 period (Newbery, 2005).

#### 326 5. Results

327 In order to derive the Engel curves for energy spending as well as for electricity and natural gas spending, we  
 328 estimate several specifications of Equation (8). The sample size is the same for the energy spending models (Model  
 329 1, restricted Model 1) and the electricity spending (Model 2) but it is smaller for gas spending (Model 3), reflecting  
 330 the fact that more than 1,000 households in the sample do not have access to gas. In all specifications we use the  
 331 FE estimator to control for cross-sectional (i.e. household) heterogeneity. For all specifications of the dependent  
 332 variable we reject the null hypothesis of no heteroskedasticity at the 5% level of significance using a modified Wald  
 333 test for groupwise heteroskedasticity. Since the random effects specification of each model is strongly rejected by the  
 334 Hausman test and the Sargan-Hansen test (rejected at the 5% level of significance, see Table 2), we do not report the  
 335 coefficients estimated by the random effects model.<sup>17</sup> The results are presented in Table 2.

336 For all models, most of the estimated coefficients are statistically significant and take the expected sign. In partic-  
 337 ular, the second and third-order coefficients of INCOME are statistically different from zero, suggesting the existence  
 338 of non-linear Engel curves. The fuel price coefficients, i.e. GAS and ELECTRICITY PRICE, are positive indicating  
 339 that energy spending as a whole and both electricity and natural gas spending are increasing in fuel prices.

340 The three variables intended to capture measurement errors in individual energy prices, i.e. the within region  
 341 differences in income (INCOME WITHIN), the gap between the average income in household's region and country  
 342 income (INCOME BETWEEN), and the dummy variable to capture differences in prices due to lack of gas connection  
 343 (NO GAS) are also statistically significant. This suggests that our modelling strategy to address the lack of individual  
 344 energy prices is justified. An alternative approach to address the absence of individual household energy prices is  
 345 to use the available regional price data as proxy for individual prices. This data is only available for the 1998-2007  
 346 period. For comparison, we show in Table A of the Appendix the regression results when we include regional prices  
 347 in our model instead of the within and between differences in income as proxy for differences in individual energy  
 348 prices. The results (see first model in Table A) were not reasonable as income coefficients are no longer significant.  
 349 We hypothesize that this is due to the shorter time period and run our previous model (see second model in Table

<sup>16</sup>The IEA data is published by the Department of Energy and Climate Change (DECC).

<sup>17</sup>These will be made available upon request to the authors.

Dep. Variable:	Model 1		Model 1 restricted		Model 2		Model 3	
	Energy Spending		Energy Spending		Electricity Spending		Gas Spending	
Variables	Coef.	t	Coef.	t	Coef.	t	Coef.	t
INCOME	1.187	4.01	1.103	3.78	0.996	3.04	0.810	1.88
INCOME SQ	-0.245	-4.00	-0.241	-3.93	-0.204	-2.97	-0.169	-1.88
INCOME TR	0.013	4.32	0.014	4.24	0.012	3.38	0.010	2.13
GAS PRICE	0.283	5.55	0.318	-13.92			0.541	38.59
ELECTRICITY PRICE	0.368	6.05	0.334	11.36	0.707	52.01		
INCOME BETWEEN	-0.225	-4.18			-0.252	-5.64	-0.127	-2.25
INCOME WITHIN	-0.066	-1.47			-0.105	-4.53	-0.060	-1.96
NO GAS	-0.174	-18.42	-0.173	-18.35	0.299	28.31		
AVERAGE AGE	-0.140	-9.01	-0.140	-9.16	-0.177	-10.27	-0.080	-3.88
CHILDREN	0.092	11.67	0.092	11.72	0.079	9.02	0.115	10.97
OWNED	0.083	9.25	0.083	9.25	0.072	7.21	0.074	5.89
DETACHED HOUSE	0.254	23.16	0.256	23.36	0.115	9.40	0.310	19.97
SEMI-DET. HOUSE	0.141	14.89	0.142	15.08	0.041	3.85	0.227	16.93
END-TER. HOUSE	0.120	11.24	0.122	11.36	0.034	2.79	0.214	14.16
TER. HOUSE	0.088	9.17	0.090	9.30	0.010	0.92	0.167	12.25
Constant	1.891	2.01	2.334	2.49	4.195	3.97	-0.209	-0.15
Observations	77,116		77,116		77,116		67,941	
Number of groups	13,573		13,573		13,573		12,149	
R-squared	0.1723		0.1682		0.1481		0.0913	
Hausman test	821.6***		941.5***		841.4***		427.2***	
Sargan-Hansen test	705.5***		650.6***		584.2***		391.1***	

Notes: \*\*\* $p < 0.01$ , \*\* $p < 0.05$ , \* $p < 0.1$

Table 2: Regression results. FE parameter estimates

350 A) for this shorter period. Again, coefficients of income variables were not significant indicating that shortening our  
351 dataset reduces the within variation of income variables, so that it produces coefficients for the income variables that  
352 cannot be justified from an economic point of view. Thus keeping a longer time dimension and hence larger dataset  
353 is important and in this context, our approach seems to perform better than including regional prices in our model as  
354 proxies for differences in individual household energy prices.<sup>18</sup>

355 In addition, the results for the variables that are used to control for household and home characteristics are rather  
356 robust in the estimated models. The coefficient for the average household age (AVERAGE AGE) is generally negative  
357 and significant. We use the number of children (CHILDREN) as an indicator of household size. The number of  
358 children has a positive and significant impact on total energy as well as on electricity or gas spending. The variable  
359 for the ownership of homes (OWNED) is positively linked to the spending levels for the different fuels. As we do  
360 not control for durable appliances it is possible that owners tend to live longer in their homes and own and use more  
361 electricity appliances and, therefore, have higher electricity expenditures. The next group of coefficients compares  
362 how fuel spending differs for households living in different types of homes. As expected, energy spending is highest  
363 for households living in detached houses and lowest for those living in flats.<sup>19</sup>

<sup>18</sup>Differences in estimation results for the whole sample and the restricted sample might be explained by the fact that the first part of our sample period coincides with a period where GDP was evolving strongly from negative to positive (and increasing) rates of growth. This issue will be addressed in future research.

<sup>19</sup>Meier and Rehdanz (2008) estimate the effect of building types on household heating expenditures per room. They find that households living

364 In the following, we discuss the coefficients and their magnitudes for the different models and then focus on the  
 365 role of income and the Engel spending curves for the different fuels.

366 Both Model 1 and restricted Model 1 refer to energy spending. The fixed effects analyses of overall energy expen-  
 367 ditures cover nearly 14,000 households in the sample, which includes more than 77,000 observations for the period of  
 368 study. As mentioned, the only difference between the two models is in the implementation of the measurement errors  
 369 of the individual prices. As can be seen from Table 2, the explanatory power of the energy spending model increases  
 370 when INCOME BETWEEN and INCOME WITHIN are included as explanatory variables since the R-squared value  
 371 increases.

372 The modelled errors in the price variables using the within and between regional price differences consistently  
 373 show negative coefficients. The coefficients are, in absolute terms, higher for INCOME BETWEEN, ranging from  
 374 -0.252 (Model 2) to -0.396 (Model 3). For the INCOME WITHIN variable, coefficients range from -0.0599 (Model 3)  
 375 to -0.105 (Model 2). It is noteworthy, that the effects are lowest for gas spending and highest for electricity spending.  
 376 The estimated coefficients are significant for all models. The F-test statistics for the joint significance of the two  
 377 variables range from 2.65 (Model 3) to 16.3 (Model 2) and the results are highly significant.

378 First, using income differences as a proxy for within and between regional price differences improves the explana-  
 379 tory power of the model. The estimated coefficients support our hypothesis, as described in Section 3: the higher the  
 380 regional income in comparison to overall UK average income the lower the spending levels of individual households  
 381 will be as they benefit from more competition and thus lower fuel prices. At the same time, a household living on an  
 382 income higher than the regional average tends to have lower energy spending. As gas is the main heating fuel, and  
 383 electricity is used for multiple purposes, this can explain the difference in magnitudes of the two variables. House-  
 384 holds might want to reach a certain level of warmth in their homes, and thus they are more likely to save money on  
 385 their electricity (and use their appliances to lower extents) rather than on their gas usage.

386 The coefficients for gas and electricity prices are positive but smaller than unity in all four models. This signifies  
 387 that an increase in prices leads to an increase in spending though less than proportionate. Households reduce their  
 388 energy consumption but their overall energy spending is higher.<sup>20</sup> The effect is similar for prices in the restricted and  
 389 unrestricted Models (1). However, an electricity price increase leads to a stronger reduction in energy consumption  
 390 than a gas price increase partly due to higher relative cost of using electricity for space heating. A one per cent  
 391 increase in the electricity price results in approximately 0.7% increase in spending on electricity. Similarly, a one per  
 392 cent increase in the gas price leads to more than 0.5% increase in spending on gas.

393 The interpretation of the NO GAS coefficient seems less obvious. It takes values of -0.17 for energy spending  
 394 and 0.299 for electricity spending. Energy spending tends to be lower for households who use only electricity or oil.  
 395 Households that do not have access to gas, tend to consume less energy. If households can use oil instead of gas,  
 396 they may use less oil than they would use gas, as oil is relatively more expensive (IEA, 2007). The impact of NO  
 397 Gas on electricity spending can be seen from Model (2). The positive coefficient for electricity shows that households  
 398 without access to gas will spend more on electricity, independent of whether or not they also use oil or solid fuels.  
 399 This is in line with evidence reported by Ofgem (2008). We argue that, due to absence of inter-fuel competition,  
 400 these households face higher electricity prices. At the same time, it may be the case that households consume more  
 401 electricity because they also use some electricity for heating. The answer is likely to be a combination of both higher  
 402 electricity price and higher levels of consumption.

403 The AVERAGE AGE variable has negative coefficients in all models and, in absolute terms, its impact is com-  
 404 paratively the lowest on gas spending. Other studies have shown that age has a strong impact on energy spending.  
 405 Meier and Rehdanz (2010) have, for example, shown an inverted U-shaped relation between heating expenditures per  
 406 room and the average age of occupants indicating that older people tend to have difficulty in warming their homes  
 407 adequately. The impact of the number of children is strongest in the case of gas spending. The comparatively high  
 408 coefficient for gas spending shows that having children drives the usage of heating to a larger extent than electricity  
 409 and overall energy spending.

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in flats have the lowest heating expenditures per room and the expenditures are highest for household living in detached houses.

<sup>20</sup>As we analyse electricity spending rather than electricity consumption, we can only hypothesize about the quantity adjustments. A price increase affects the budget constraint and households may simply reduce the consumed quantities of electricity and gas at the same time. Baker et al. (1898) find a large (negative) own price elasticity for electricity consumption. The cross price elasticity (gas) is positive. If electricity price increases while gas price is unchanged, households switch to gas and consume less electricity. Own price elasticity of gas consumption is smaller (negative), and the cross price elasticity is negative as well indicating some degree of complementarity in consumption of electricity and gas.

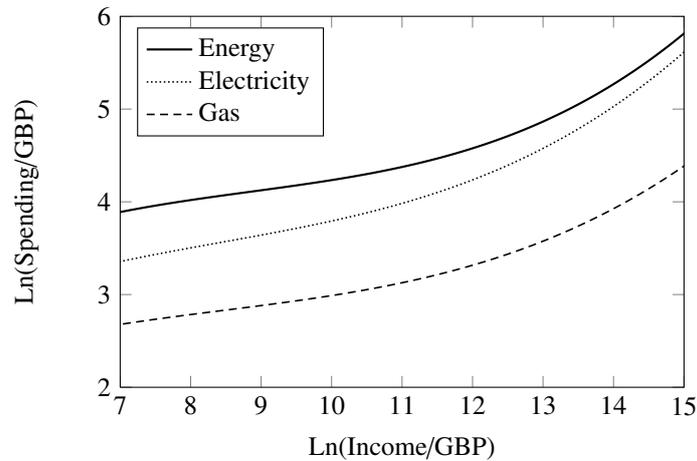


Figure 2: Engel spending curves for energy, electricity and gas<sup>21</sup>

410 The variable for the ownership of homes, OWNED, is positively linked to total spending on energy as well as to  
 411 gas and electricity. Coefficients are highest for overall energy spending (0.083) and lowest for electricity spending  
 412 (0.072). Also, Meier and Rehdanz (2010) have shown that heating expenditures are highest for owners. They argue  
 413 that only a small proportion of households rent accommodation, and renters mainly live in flats while owners tend to  
 414 live in other building types. Flats generally have lower heat loss-levels than, for example, detached houses.<sup>22</sup> This is in  
 415 line with our findings with respect to building types. Spending on energy, electricity, and gas is highest for households  
 416 living in detached houses and lowest for those living in flats. The difference between the impacts of building types  
 417 is highest for gas spending. Here, the coefficient for DETACHED HOUSE is highest (0.31) while it is lowest for  
 418 electricity spending (0.115). Again, the main driver of the difference in coefficients is the usage of the fuels. Gas bills,  
 419 which mainly include spending on heating, depend to a larger extent on building type (and size), and detached houses  
 420 have higher heat loss levels. Differences in the effect of building types on electricity usage might be linked to the size  
 421 of homes as well as the number of residents. More space means that more electric appliances may be used.

422 Finally, we explore the third order function of income, i.e. the Engel spending curves for energy, electricity and  
 423 gas. Looking at the first two models, ENGEL curves appear quite similar. Only the coefficient for the first order  
 424 INCOME is higher in Model (1). A comparison of the coefficients of the three income variables shows a positive  
 425 coefficient for INCOME, a negative coefficient for INCOME SQ and a positive coefficient for INCOME TR. This  
 426 means that our ENGEL curves are S-shaped and spending for energy does not continuously increase in income at the  
 427 same rate. This result is persistent for all four models, i.e. for energy, electricity as well as gas spending. However,  
 428 the coefficients differ in magnitude. The Engel curve for gas spending starts at the lowest level of income and is located  
 429 below the energy and the electricity spending curves. As gas is predominantly used for heating, households may try to  
 430 keep a certain level of warmth and, therefore, income changes do not affect gas spending strongly. Households may,  
 431 however, reduce spending on other goods rather than cutting on heating. On the other hand, an increase in income  
 432 can encourage households to acquire more appliances which in turn leads to a stronger response to income changes  
 433 in electricity and thus overall energy spending. Figure 2 illustrates the Engel spending curves based on the results of  
 434 estimations for Models (1), (2) and (3), as given in Equation (3).

435 The income-spending curves show how energy, electricity, and gas spending increase in income. For our range of  
 436 income, no local minimum or maximum can be identified. In order to better understand these curves, we examine the  
 437 first derivatives of the functions of household income as in Equation (13).

<sup>21</sup>Here we draw energy spending over income ranging from more than 1,000 (ln 7) to more than 3,000,000 (ln 15).

<sup>22</sup>Meier and Rehdanz (2008) estimate the impact of building types on household heating expenditures per room. They find that households living in flats have the lowest heating expenditures per room and the expenditures are highest if a household lives in a detached house.

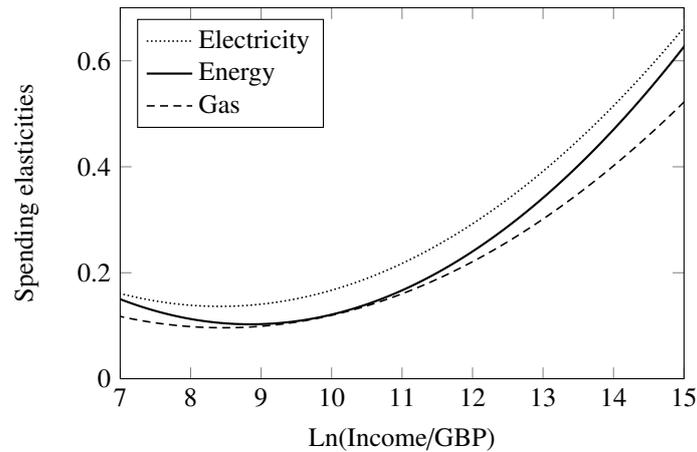


Figure 3: Income elasticities of energy, electricity and gas spending<sup>23</sup>

438 The first derivative shows how energy spending changes with income and thus represents a function of income  
 439 elasticity for energy, electricity, or gas spending:

$$\frac{\partial \ln f(Y_{it})}{\partial \ln Y_{it}} = \alpha_1 + \alpha_2 \ln Y_{it} + \alpha_3 (\ln Y_{it})^2 \quad (13)$$

440 The income elasticities for all fuels, together or separately (Figure 3) do not exceed unity, indicating that an increase  
 441 in income (at any level) leads to a less than proportionate increase in energy spending. Inflection points of the fuel  
 442 spending curves and thus local minima of the elasticity functions vary for energy, electricity, and gas spending.<sup>24</sup>  
 443 Nevertheless, all of them occur at low income levels: the gas spending curve turns at an income level of roughly  
 444 GBP 4,800, while the electricity and overall energy spending curves turn at approximately GBP 4,600 and GBP 7,200  
 445 respectively.<sup>25</sup> Beyond these income levels a further increase in income is spent on fuels at an increasing rate. The  
 446 increase in elasticity can also be interpreted as that, at higher levels of income, energy and in particular electricity  
 447 gradually begin to gain the attributes of luxury goods.<sup>26</sup>

#### 448 *The Unit Effects and Long Run*

449 So far we have focused on households' energy spending adjustment processes in the short run. These processes  
 450 might change in the long run since households might buy new appliances or undertake measures to improve the energy  
 451 efficiency of homes impacting on their energy spending. In order to gain insights about the long run effects, we explore  
 452 the cross-section set of unit effects that allow us to approximate the long run relationship between energy spending  
 453 and income (Kennedy, 2003).

$$E_{it} = \beta X_{it} + \gamma Z_i + \alpha_i + \epsilon_{it} \quad (14)$$

454 where  $E_{it}$  is energy spending in  $\ln$ ,  $X_{it}$  is a  $K \times 1$  vector of time-varying explanatory variables,  $Z_i$  is a  $P \times 1$  vector  
 455 of time-invariant explanatory variables,  $\epsilon_{it}$  is the idiosyncratic error term, and  $\alpha_i$  captures the effect of unobserved

<sup>23</sup>The income elasticity of the energy spending curves is depicted in Figure (3). As shown in the graph, all elasticities first decrease and then increase in income. First, this shows, that the second derivative of the third order function of income has an inflection point. This inflection point is also at the local minimum of the income elasticity function. Accordingly, starting from very low levels of income, an increase in income leads to an increase in spending on different fuels although this will take place at a decreasing rate. Also, see Pudney (2008) for discussion of some issues related to the use of survey and income data.

<sup>24</sup>The local minimum can be obtained from (13) after taking the log-derivative and solving for the income level, i.e.  $\gamma' = \exp(-\alpha_2/2\alpha_3)$ .

<sup>25</sup>In our sample, we have 2,446 households with an income below GBP 4,600 and nearly 8,000 observations with an income below GBP 7,200.

<sup>26</sup>Based on our model estimation, we calculate an income elasticity of spending on the different fuels at the sample mean (GBP 26,293  $\approx \ln(10)$ ) for gas and overall energy spending equal to 0.12% and for electricity equal to 0.17%.

	Coef.	Std. Err.	t-ratio
INCOME	0.413	0.0034	120.03
Constant	5.709	0.0337	169.08
R-squared	0.4681		
Obs.	16,371		
Dep. Var.	Smoothed log income (using the Hadrick-Prescott filter)		

Table 3: Parameter estimates of the permanent income equation (OLS)

time-invariant individual characteristics. From the first stage FE regression we can get the estimated unit effects as follows:

$$\hat{\alpha}_i = P_D(E - Xb_{FE}) = \bar{y}_i - \bar{X}_i b_{FE} \quad (15)$$

where  $b_{FE}$  is the fixed effects estimate and the projection matrix  $P_D$  allows us to get a vector of group means. In the second stage, the estimated unit effects (of the FE models) are regressed on the group means of the explanatory, time-varying variables (and also on the observed time-invariant variables, but we omit this for notational ease):

$$\hat{\alpha}_i = \alpha + \rho \bar{X}_i + \omega_i, \quad \omega_i \sim N(0, \sigma_\omega^2) \quad (16)$$

where  $\rho$  are parameters estimated using OLS. Thus, the unit effects are decomposed into a part explained by the available between-unit information contained in  $X$ , and an unexplained part that corresponds to the residual from this second stage regression. Note that, following Kennedy (2003), this model uses only one cross-section, so OLS would produce an estimate of the long-run relationship between energy consumption and income if the relationship between unit effects and the vector of group means is not spurious but is caused by economic performance. In order to be more precise, using (14) and (16) we write the long-run elasticity of energy spending with respect to income as follows:

$$\frac{dy_{it}}{dX_{it}} = \beta + \frac{d\hat{\alpha}_i}{dX_{it}} = \beta + \frac{d\hat{\alpha}_i}{d\bar{X}_i} \cdot \frac{d\bar{X}_i}{dX_{it}} = \beta + \rho \cdot \frac{d\bar{X}_i}{dX_{it}} \quad (17)$$

where we assume that the log of income is measured by  $X$ . If short-run changes in income are completely “permanent”, then  $d\bar{X}_i/dX_{it} = 1$ , and the long-run elasticity is equal to  $\rho + \beta$ . However, we expect that only a small part of the short-run changes in income is permanent, and hence the above derivative must be less than unity. An estimate of this derivative can be obtained if we first use the Hadrick-Prescott filter to smooth  $X$ , and then regress the “smoothed” variable against the original one. Despite its simplicity, this empirical strategy allows us to shed some light on households’ long run adjustment processes.<sup>27</sup>

Table 3 shows the estimated coefficients of a complementary regression using the “smoothed” income variable as dependent variable. The slope of this equation is the derivative of the “smoothed” income variable with respect to the original income. As shown in Table 3, the estimated derivative is about 0.41 using OLS. This also seems to be reasonable (it is less than 1, as expected).

The regression results for the estimated unit effects (equation 16) using only logs of income as regressors are shown in Table 4. Using the estimated coefficient of Table 3 and 4, we also show the long and short run elasticities evaluated at the sample mean. The coefficients of the group means of the third order function of income show similar

<sup>27</sup>It should be noted that our strategy to estimate long-run elasticities relies on previous estimates of the unit effects using equation (15). These estimates are consistent provided that  $T \rightarrow \infty$ . When  $T$  is not large enough,  $\hat{\alpha}_i$  is inconsistent because the individual averages  $\bar{y}_i$  and  $\bar{X}_i$  do not converge if the number of individuals increases (see Verbeek, 2008). Therefore, in order to estimate long-run elasticities, it is important to use the maximum number of years. If instead of using our price modelling approach, we use the regional price data that is available for fewer years, the analysis no longer produces meaningful results.

	Model 1		Model 1 restricted		Model 2		Model 3	
	Coef.	t	Coef.	t	Coef.	t	Coef.	t
MLINCOME*	6.259	20.08	6.216	19.84	5.099	15.12	6.125	13.41
MLINCOME SQ*	-1.296	-20.05	-1.283	-19.75	-1.007	-14.39	-1.300	-13.73
MLINCOME TR*	0.067	20.14	0.066	19.76	0.050	13.78	0.069	14.09
Constant	-20.239	-20.24	-20.154	-20.05	-17.264	-15.95	-19.257	-13.13
R-squared	0.019		0.017		0.012		0.008	
Observations	77,116		77,116		77,116		67,941	
RHO	0.063		0.039		0.020		0.040	
Short-run elasticity	0.127		0.061		0.174		0.127	
$dX_i/dX_{it}$	0.413		0.413		0.413		0.413	
Long-run elasticity	0.153		0.077		0.182		0.143	
LR/SR ratio	1.205		1.269		1.047		1.129	

\*Group means of third order function of income variables.

Table 4: Second stage estimation of unit effects.<sup>28</sup>

480 signs and magnitudes as for the short run fixed effects estimations. The computed short run elasticities for the group  
 481 sample mean are all positive and less than one. The same applies for the long-run elasticities which are at the same  
 482 time larger than their short run estimates.

483 The approximated long-run behavior suggests that households' change in energy spending due to changes in  
 484 income is, on average larger than in the short run. That is in the long run, an increase in income leads to a stronger  
 485 increase in energy spending than in the short-run. The long-run elasticity is strongest for electricity spending which  
 486 is in line with the assumption that, over time, households use more electricity consuming appliances. But since gas  
 487 spending increases strongest over time, it also implies households heat their existing homes to a larger extent, or even  
 488 move to larger homes that require more gas spending to achieve a certain level of warmth.

## 489 6. Conclusion

490 This study explored the link between household energy spending and income while also analyzing other drivers of  
 491 energy spending such as socio-economic determinants or building characteristics. We also examined the differences  
 492 in spending on total energy, electricity and gas.

493 Our findings show that total spending on energy as well as on electricity and gas increase in income. The increase  
 494 in spending initially slows down until it reaches a minimum at annual household income levels below GBP 8,000.  
 495 Beyond this income level spending on energy as well as on electricity and gas rises at an increasing rate. The estimated  
 496 Engel spending curves are slightly S-shaped.

497 The identified inflection points of energy spending-income curves occur at rather low levels of incomes. House-  
 498 holds on incomes below such levels will use additional income initially to cover spending on other necessities such  
 499 as food or clothing. However, using this income level as threshold where basic needs are met can be arbitrary. These  
 500 households may simply only have choices between spending on food or heating and lighting.

501 Returning to Engel's statement about the welfare being dependent on the extent to which the needs of citizens can  
 502 be met and thus costs of living can be covered and recalling Bradshaw's analysis of income and spending thresholds  
 503 where basic needs are met, we come to the following conclusions. As household spending on fuels increases in

<sup>28</sup>In this estimation we use the whole set of observations (77,116). This approach allows us to give more weight to those households with more annual observations and thus we use a weighted-type OLS estimator.

504 income, the needs of households increase in income as well. Thus, the effort of covering costs of living becomes more  
 505 complex the higher the income. Looking at spending on gas and linking this to spending on heating, we have shown  
 506 that the link between income and gas spending is not as strong. Although gas spending also increases at an increasing  
 507 rate in income the impact is not as strong as for electricity.

508 The shapes of the Engel spending and the elasticity of spending curves reflect the changing nature of consumption  
 509 of energy, electricity, and gas as income changes. At very low levels of income households prioritize within their  
 510 budget allocation between energy and other necessities. First, an increase in income is used to a larger extent to pay  
 511 for food, health services, and homes. The quality and the quantity of these goods consumed probably changes first.  
 512 Even though some of the additional income is spent on energy (the income elasticity is always larger than zero), it is  
 513 only if income continues to increase that energy spending will, at some stage, increase at an increasing rate.

514 Energy is used for different types of consumption and as income changes the composition of the consumption  
 515 changes. Some energy consumption is used for necessities such as heating and lighting, while some is used for  
 516 normal goods, such as the usage of electrical appliances. But as income increases, the share of energy dedicated to  
 517 luxury goods tends to increase and thus income elasticity of spending becomes larger at an increasing rate. Leisure  
 518 activities and energy intense appliances will account for a larger share of the energy consumption mix. A rather  
 519 general approximation of long run adjustment processes in energy spending shows that in the long run household  
 520 energy spending increases to a larger extent in rising income than in the short-run.

521 Given the results and discussion in this study, we cannot recommend the use of budget thresholds or the definition  
 522 of income levels where households seem to meet their basic needs. The change in household energy consumption is  
 523 an individual process depending on a range of factors. Fixing energy consumption at an optimal level can only be  
 524 arbitrary and will not fully satisfy the needs of consumers. We therefore suggest the exploration of transfer payments  
 525 that allow households to find their own individual utility maximizing level of warmth and appliance usage. This would  
 526 probably be a more efficient policy measure to overcome the increasing energy divide among households. Policies  
 527 targeting residential energy use, climate change, energy efficiency of homes, energy affordability, and fuel poverty  
 528 need to take income and other differences among households into consideration as consumer response to changes in  
 529 income and energy prices will differ according to their initial level of income.

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Dep. Variable: Variables:	New Specification		Old Specification	
	Energy Spending Coef.	t	Energy Spending Coef.	t
INCOME	0.440	1.23	0.719	1.95
INCOME SQ	-0.099	-1.34	-0.109	-1.47
INCOME TR	0.006	1.45	0.006	1.58
GAS PRICE Region	0.527	8.72		
EL PRICE Region	0.156	2.03		
GAS PRICE (Annual)			-0.068	-0.48
EL PRICE (Annual)			0.858	4.72
INCOME BETWEEN	0.133	1.8	-0.183	-1.72
INCOME WITHIN	0.042	0.78	-0.193	-1.98
NO GAS	-0.170	-15.11	-0.170	-15.12
AVERAGE AGE	-0.090	-4.24	-0.102	-4.81
CHILDREN	0.112	10.26	0.109	9.99
OWNED	0.100	8.6	0.099	8.55
DETACHED HOUSE	0.257	17.39	0.256	17.34
SEMI-DET. HOUSE	0.143	11.46	0.143	11.47
END-TER. HOUSE	0.120	8.7	0.120	8.68
TER. HOUSE	0.100	7.87	0.099	7.86
Constant	4.559	3.53	5.306	4.49
Observations	55,509		55,509	
Number of groups	11,451		11,451	
R-squared	0.1711		0.1704	

Table A: Regressions with and without regional average prices (1998-2008)