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Chapter 6

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You Can't Drill It There — But Maybe Over Here: Practical Issues to Consider in Preparing a Coalbed Methane Lease from a Coal Development Perspective

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Synopsis

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§ 6.01. Introduction.

This chapter assumes that your client — whether a coal lessee, coal lessor or landowner — has made the business decision to lease coalbed methane (CBM) exploration and development rights on real property containing coal reserves, whether the reserves are developed or yet to be developed. As verified by statistical evidence from the United States Environmental Protection Agency's (U.S. EPA) Coalbed Methane Outreach Program (CMOP),[2] this scenario has become more prevalent in recent years. EPA's CBM Outreach Program encourages the capture and utilization of coalbed methane as an energy resource and as a mechanism to decrease the release of methane during mine ventilation. As reported by CMOP, in the period from 1989 to 1996, U.S. coalbed methane production increased from under one percent of gross natural gas production to over five percent of such production[3] — from less than 100 Bcf to over 900 Bcf.[4] During this period, coalbed methane produced from active coal mines increased from less than 15 Bcf to approximately 40 Bcf.[5]

Several reasons caused this growth in CBM production. In 1980, Congress passed the non-conventional fuels tax credit in Section 29 of the Federal Windfall Profits Act,[6] which spurred development activity

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2 U.S. EPA Coalbed Methane Outreach Program, Mail Stop 6202J, 401 M Street, S.W., Washington, D.C. 20460.

3 Data recorded from CMOP files recounting CBM statistics recorded at <http://epainotes1.rtpnc.epa.gov:7777/dc\Methane\HOME.NSF/Lookup/762587F617C87D9B852564960074A352>. On file with author.

4 *Id.*

5 *Id.*

6 Federal Windfall Profits Act of 1980, 26 U.S.C. § 29 (1996). Section 29 provides:

> There shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to – (1) $3, multiplied by (2) the barrel of oil equivalent of qualified fuels – (A) sold by the taxpayer to an unrelated person during the taxable year, and (B) the production of which is attributable to the taxpayer.

26 U.S.C. § 29(a). For the purposes of this section, "qualified fuels" include gas produced from coal seams. 26 U.S.C. § 29(f)(B)(1). The tax credit is allowed under this section for qualified fuels sold by January 1, 2003 that were produced from a facility placed in service or drilled between January 1, 1980 and December 31, 1992 or from wells drilled between January 1, 1980 and December 31, 1992. 26 U.S.C. § 29(f).

among traditional gas producers. Coal producers found that even a modest revenue stream from CBM wells could offset huge mine ventilation costs,[7] as well as enhance mine safety during on-going coal operations.[8] Federal and state legislation was enacted to foster the production of CBM,[9] and

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See Bruce Levy & Andrew Rosenlieb, "Producing Natural Gas from Coal Seams," 127 No. 12 *Pub. Util. Fort.* 53 (June 1991)(discussing benefits of alternative energy tax credits); *see also* Todd A. Fisher & Bruce N. Lemons, "IRS Clarifies Availability of Fuel Credit As Time for Drilling Expires," 73 *J. Tax'n* 342 (Nov. 1990)(providing pre-amendment discussion of Internal Revenue Service's interpretation of Section 29 application).

7 Professor Jan M. Mutmansky of The Pennsylvania State University has published extensively on the economic benefit of the degasification of coal seams. *See* J.M. Mutmansky & Aiping Wang, "Patterns of Methane Emission and Their Effects on Mining Costs in Underground Mining Operations," 51 *Min. Eng'g* 65, 69-70 (January 1999)(concluding that drainage of methane gas from underground coal mines creates economic benefits sufficient to defray drainage costs); Jeongheum Kim & Jan M. Mutmansky, "Comparative Analysis of Ventilation Systems for a Large Scale Long Wall Mining Operation in Coal Seams with High Methane Content," 3 *Min. Res. Eng.*, 99 (1990)(analyzing study of three ventilation schemes for long well panels in coal seams with high methane content and impact of coalbed methane extraction on operating and ventilating costs); A. Wang & J.M. Mutmansky, "Economic Decision Making for Methane Drainage Systems for Underground Coal Mines," 50 *Min. Eng'g* 69, 72 (March 1998)(discussing merits of methane drainage systems); *see also* Yanabei Wang & Jan M. Mutmansky, "Economic Analysis of Coalbed Methane Drainage Systems for Room-and-Pillar Operations" *Eighth U.S. Mine Ventilation Symposium*, University of Missouri-Rolla, Rolla, MO.

8 Examples of CBM wells developed in conjunction with on-going coal operations include the CONSOL and Pocahontas Gas Partnership work on the former Island Creek properties in southwest Virginia. *See* Jeff L. Lewin, "Coalbed Methane: Recent Court Decisions Leave Ownership 'Up in the Air' But New Federal and State Legislation Should Facilitate Production," 96 *W. Va. L. Rev.* 631, 671 n. 96 (1994)(discussing increase in Virginia CBM production resulting from enactment of forced pooling legislation).

9 In 1990, Virginia enacted the "Virginia State Oil and Gas Act" to facilitate the development of oil and gas exploration by resolving conflicting interests of parties affected by such exploration. Va. Code Ann. Sections 45.1-361.1 *et seq.* (Michie 1995). The language of the Virginia legislation, while not explicitly mentioning coalbed methane, is broad enough to encompass coalbed methane exploration. *Id.* The Act requires permits for drilling wells and establishes guidelines for permit applications. Va. Code Ann. Section 45.1-361.27 (Michie Supp. 1997). Congress modeled language in the National Energy Policy Act of 1992 (EPACT), 42 U.S.C. Sections 13201 *et seq.* (1997), after the Virginia legislation, and included provisions encouraging CBM exploration. EPACT created a default program to enact CBM ownership legislation in states where the United States government maintained significant coal resources and no state program existed. EPACT allowed the designated states three years to enact state legislation on the issue or the

now there is greater cooperation between mining engineers and CBM developers in resolving conflicts such as well location during concurrent development.[10] This chapter will focus on practical solutions to issues likely to arise in coalbed methane lease negotiations.

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federal legislation would become effective. *Id.* The coalbed methane provisions of EPACT place heavy emphasis on developing new coalbed methane capture technology and resolving ownership disputes. Hazel O'Leary, U.S. Department of Energy, *Energy Policy Act of 1992 Implementation Status Report* 13 (1993).

West Virginia, designated an affected state under EPACT, enacted legislation governing CBM exploration in 1994. W. Va. Code Section 22-21-1 *et seq*. (1994). West Virginia was removed from the EPACT list of affected states on December 8, 1994. 59 *Fed. Reg.* 63376. Of the three legislative enactments, the West Virginia legislation provides the least encouragement for coalbed methane exploration, exhibiting a strong preference for coal mining when the two pursuits conflict. *Id.*

Seemingly, the legislation has increased coalbed methane exploration, even in West Virginia. Prior to the enactment of the Virginia State Oil and Gas Act, coalbed methane production in Virginia was negligible. *See* United States Environmental Protection Agency, Coalbed Methane Legislation and Recovery in Alabama, Pennsylvania, Virginia, and West Virginia 3, November 1997, available in the documents on-line section of the CMOP web page at <http://yosemite.epa.gov/methane /homensf/pages/cmop>. In 1997, Virginia's CBM gas production comprised 68 percent of its total gas production. Commonwealth of Virginia, Department of Mines, Minerals and Energy, 1997 Gas and Oil Report, Statistical Summary of the Development of Gas and Oil Resources in the Commonwealth (June 1998). A copy of that report is available from the Division of Gas and Oil, 230 Charwood Drive, P.O. Box 1416, Abingdon, VA 24212, telephone (540) 676-5423, and fax (540) 676-5459. Likewise, after West Virginia enacted its coalbed methane statute CBM drilling permits tripled. *See* United States Environmental Protection Agency, Coalbed Methane Legislation and Recovery in Alabama, Pennsylvania, Virginia, and West Virginia, *supra*. Indeed, it has been suggested by some industry analysts that "climate change credits" similar to credits under the Clean Air Act, may be added to future legislation as an additional incentive for the economic exploration and production of coalbed methane (rather than its discharge into the atmosphere).

For an in depth comparison of the federal, Virginia and West Virginia coalbed methane statutes, see Elizabeth A. McClanahan, "The Past, Present and Future of Coalbed Methane Case Decisions and Coalbed Methane Legislation," *Landman*, 41 (March/April 1999); and Elizabeth A. McClanahan, "Comparison of Coalbed Methane Statutes in the Federal, Virginia, and West Virginia Jurisdictions," *Landman*, 47 (July/Aug. 1995).

[10] Proper planning between the CBM exploration companies and mining engineers can work to the benefit of both parties. Coal operators have recognized several benefits from pre-mining extraction of CBM from the coal seam. For example, if CBM extraction is initiated eight years before mining commences, 75 percent to 80 percent of the CBM can be removed from the coal seam. *See* Levy & Rosenlieb, *supra* note 5 at 53. Also, vertical drilling for CBM causes fractures in the coal seam that allow fluid surrounding the coal to drain prior to mining. This allows for deeper mining into the coalbed. *Id.*