William McGowan and MCI: A New World of Telecommunications

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Bill McGowan, president of MCI, in 1987.

In the 1960s, Microwave Communications Inc. (now known as MCI), a tiny company with a handful of employees and no revenue, decided to engage AT&T in hand-to-hand combat. What ensued was a decades-long duel that pitted the meager resources of the upstart MCI against AT&T's arsenal of industrial, financial, and legal firepower; by comparison, David and Goliath were evenly matched.

In the 1960s, competition in telecommunications was not only nonexistent, it was illegal. AT&T, which literally had invented the industry, had held a government-regulated monopoly on long-distance phone services since 1910. By 1967 its budget was larger than that of a small European country; its assets exceeded those of Standard Oil, General Motors, Ford, and IBM combined. AT&T was the paragon of American industry, the largest private-sector employer in the nation, and the issuer of its most widely held stock. Ma Bell possessed 100 percent universal brand recognition, extraordinarily deep pockets, and, in Bell Labs, one of the world's greatest research and design facilities.

But the underdog MCI had one thing that AT&T lacked: the visionary CEO Bill McGowan. He meant to make telecommunications history by breaking up AT&T's monopoly on long- distance service, and establishing competition in an industry that had none. He did just that.

The Origins of an Upstart Company

The story of Microwave Communications Inc. begins in 1963, when John Goeken, a former General Electric two-way radio salesman and inveterate tinkerer from Joliet, Illinois, asked the Federal Communications Commission (FCC) for permission to set up private phone lines connecting St. Louis and Chicago. Goeken hit upon the revolutionary idea of allowing many customers to tap into a private microwave system—a fairly standard technology in which conversations were carried by a form of radio wave. These waves were transmitted via antennae mounted atop microwave relay stations, each within a direct line of sight to the next. Under Goeken's proposal, companies with operations in both cities could pay a flat monthly fee, tap the line, and connect directly to their colleagues. This differed from AT&T's system, which consisted of copper-wire strung between every city and town in the United States.

But Goeken couldn't proceed without FCC approval. And while he waited for it, his fledgling Microwave Communications ran dangerously low on funds. Goeken traveled the country tirelessly, trying to raise

funds through insurance companies, banks, and wealthy individuals. Eventually, a lawyer told Goeken about a prospective source of venture capital: William McGowan, a forty-year-old corporate turnaround artist and self-made millionaire whose background was more blue collar than blue chip.

William McGowan grew up in Ashley, Pennsylvania, near Wilkes-Barre, the son of a railroad engineer. He worked nights as a freight dispatcher for the New Jersey Central Railroad to pay the tuition at a local college where he studied chemistry. In 1954 young McGowan graduated in the top 5 percent of his class at Harvard Business School. A natural entrepreneur, McGowan set up shop as a consultant in New York and started a small venture capital company whose specialty was helping troubled companies get back on their feet. He became a sort of patron saint for seemingly lost corporate causes. But after turning around the fortunes of a handful of failing companies, McGowan grew bored doing the "same things over and over again." He spent the next year touring around the globe with his brother, who was a Catholic priest, and consulting for UNESCO on ways of bringing venture capital to third-world small businesses.

A Vision for the Future of MCI

Upon his return, McGowan was approached by John Goeken and found a new challenge in MCI's push for an FCC license. Viewing the license as a beginning, not an end, McGowan foresaw a future for the company far greater than its founder Goeken had envisioned. McGowan wanted nothing less than a nationwide network connecting major hubs through which MCI could offer low-cost, long-distance service to the business market. After three months of discussions with Goeken and other MCI executives, McGowan took control of MCI in 1968 by injecting a much needed \$35,000 into the poorly capitalized company.

After holding several rounds of hearings, commissioning various professional studies, and entertaining objections and counter-objections from MCI and AT&T, the FCC finally granted the license in August 1969. In a 4 to 3 split decision, the commissioners ruled that by offering semiprivate lines to mid-sized and small businesses, MCI met "unfulfilled communications needs." The government believed that this first serious challenge to AT&T's monopoly would have the salutary effect of shaking up Ma Bell, which, it felt, had grown slack and inattentive to customers' needs. "MCI," the Commissioner Nicholas Johnson wrote, "would add a little salt and pepper of competition to the rather tasteless stew of regulatory protection that this commission and Bell have cooked up." Over the next twenty years, McGowan would add a great deal more than spice to the telecommunications stew.

McGowan lived vigorously in all respects: he was a relentlessly aggressive and successful salesman, a heavy smoker, unabashed bachelor, and an energetic proselytizer who would devote most of his life to MCI. He was described by the press as "a paunchy, chain-smoking workaholic with a chronic disregard for rules," a friendly presence "with a bit of Mephistopheles thrown in."

McGowan's sales campaign began on the inside, with endless pep talks to staffers and investors, in which he sold them on the easy money that lay just beyond the legal and regulatory tangle. In reality, for most of its early years, MCI was more a fund-raising firm than a communications company. In 1973, MCI had 4,500 miles of routes, but was operating only the St. Louis-Chicago connection. Worse, MCI couldn't offer its services without the cooperation of AT&T. After all, any call from Chicago to St. Louis would have to originate on an AT&T local line in Chicago, switch to the MCI long-distance line, and then switch back to an AT&T line to an office in St. Louis.

In 1972, as the Chicago-St. Louis link became operational, McGowan started negotiating with AT&T for access to its local lines. Although McGowan's operation barely existed, Ma Bell saw MCI—indeed, any competition—as a mortal threat. To complicate the situation, AT&T was suffering a quiet crisis of confidence due to agitation from consumer advocates and constant customer complaints about declining quality of service. Despite its own problems AT&T's 1972 Presidents' Conference in Key Largo, Florida, focused on MCI. As MCI expanded from its Chicago-St. Louis base and sought business customers all over the country, AT&T's regional

executives had thus far refrained from confronting MCI head on. But now they wanted to fight. "I would meet 'em or beat 'em," said Northwestern Bell's President, T. S. Nurnberger, who recommended that AT&T match MCI's low rates: "[Those] bastards are not going to take away my business." John Dulany deButts, a company veteran installed as chairman just six weeks prior to the meeting, was still finding his footing, however, and decided against precipitate action.

McGowan, in contrast, knew exactly what he wanted to do. On January 9, 1973, he laid out a long-range course of action to his executives in Washington, D.C. His plan included preparing an antitrust lawsuit against both AT&T and its local operating companies, sending briefs to the Federal Communications Commission, and goading the Justice Department into taking similar antitrust action. But the boldest of his new tactics was to undertake blunt face-to-face confrontation with AT&T's head office: "The first thing we should pursue is high-pressure negotiations with 195 Broadway."

To McGowan, deButts and company offered an object lesson on how not to run an organization. While working for the New Jersey Central Railroad, young McGowan had first seen the pitfalls of the multilayered corporate structure. He described such an organization as having "bureaucratic procedures. Procedure upon procedure, with no apparent rationale." This was the AT&T weakness that McGowan's nimble firm planned to exploit. As *The Wall Street Journal* noted in 1985: "Mr. McGowan has said, only half facetiously, that he runs the company by observing what AT&T does and then bolting in the opposite direction."

War Is Declared

On March 2, 1973, McGowan stood toe to toe with AT&T Chairman John deButts, the courtly scion of a Southern railway family. The contrast in the styles and personalities between them made open conflict inevitable. DeButts, perfectly suited to his plush twenty-sixth-floor office, complete with gold carpets and antiques, represented a way of corporate life McGowan had rejected. The conversation between the two chairmen quickly degenerated into threats. McGowan attacked AT&T's new "Hi/Lo" pricing systems, introduced in February 1973 to counter MCI's bid for a piece of the action. Hi/Lo offered lower rates on so-called high-density lines (i.e., the same routes between large cities in which MCI operated). McGowan declared war: "We're going to fight Hi/Lo at the FCC, and we have better relations with the FCC than you do. We also have a number of friends in Congress." When deButts apparently dismissed McGowan's threats, McGowan insolently turned up the heat. "I have plenty of money. I can spend it on litigation, or I can spend it on construction. I would prefer to spend it on construction."

This meeting marked a turning point in AT&T's view of its junior competitor. After McGowan left in frustration, deButts turned to another AT&T executive and remarked: "Nothing about MCI can be treated as business as usual."

McGowan's bravado would prove difficult to back with action. Indeed, in the early 1970s, MCI—though it was later dubbed Money Coming In—lost money hand over fist. Between 1968 and March 31, 1974, MCI brought in just \$728,000 in revenues. From 1968 through December 31, 1975, MCI had cumulative losses of \$96.2 million. As a result, in April 1973, McGowan scaled back plans for the network from thirty-four cities to nineteen cities.

Despite the disappointment, he didn't give up. Having plowed through the \$100 million in seed money raised a few years earlier, he raised \$30 million in a 1972 initial public offering. Then McGowan rounded up \$64 million in bank loans and another \$17 million in equity from private investors, adding a total of \$111 million to the company's war chest.

For the bankers and money managers, subscription to MCI's equity and loan offerings was tantamount to enrolling in Bill McGowan's audacious struggle for freedom from Ma Bell's monopoly. "It is obvious that Wall Street is prepared to use its resources to put some flesh on the bare bones of this daring challenge to the

communications establishment," one trade publication noted. McGowan's investment bankers, who handled the selling pitches, weren't just selling stock certificates, they were selling a new era.

McGowan, of course, reveled in the role. He gleefully tweaked AT&T with such comments as "Ma Bell is a lying Mother." And at the 1988 MCI shareholder meeting he compared AT&T to Stalin's regime. He delighted in showing visitors to his mansion in Georgetown a unique feature that happened to be in the house's cornerstone: an ancient AT&T logo with a crack running through it.

Friends in the Right Places

McGowan's Georgetown address subtly highlights one key to MCI's success. Few CEOs of major companies chose to live in Washington, D.C., the province of regulators, bureaucrats, and politicians. But McGowan set up shop there precisely because he understood the complex relationship between government and regulated businesses such as telecommunications. As he said in 1986: "If we did not succeed in changing the regulatory situation, then all the rest was just show biz."

McGowan realized that he could create a working venture with government: "Look, government is a reality of life," he said. "Denying it—getting emotional about it—is just letting your own personal, political biases influence your business judgment." From MCI's base in a twelve-story building near DuPont Circle, McGowan regularly entertained congressional and federal staffers, and hired Washington lawyers (like former FCC Commissioner Kenneth Cox) who knew the federal bureaucracy intimately.

McGowan's high-priced lawyers and engineers went to work, looking for ways to get around the restrictions that protected mighty AT&T. In late 1973 MCI had introduced a service called Execunet, which would allow MCI customers to use their AT&T phones to dial a local access code, then punch in an authorization, area code, and number for long-distance service. The call would then bullet over an MCI line to another city, where the signal would switch to local phones through AT&T lines. Execunet cost 10 percent to 30 percent less than Bell's competing WATS line. But the empire quickly struck back. AT&T announced that it would simply refuse to allow any additional MCI's Execunet customers to use its switches. When a court ordered AT&T to provide all interconnections to MCI's Execunet lines, Ma Bell appealed. For his part, McGowan responded with a gesture that could have been viewed as either a brilliant stroke of intuition or a foolishly suicidal gesture. On March 6, 1974, MCI filed a far-reaching lawsuit against AT&T, charging that AT&T violated federal antitrust laws by refusing intracity connections. With this stroke, McGowan engaged AT&T's massive legal apparatus in what seemed to be a one-sided contest. Throughout the 1970s, MCI and its six lawyers and twenty-four paralegals spent about \$2 million on legal costs. A substantial sum, but a pittance compared to the millions that fueled AT&T's dozens of in-house lawyers and outside counsel.

Fortunately for McGowan, MCI wasn't the only party fighting AT&T in the courts. The Justice Department's antitrust division had long been looking into AT&T's business practices, and on November 20, 1974, the Ford Administration filed an antitrust suit against AT&T, alleging monopolization of the long-distance and equipment markets. The government sought structural remedies and the break up of local telephone companies from the Bell system.

The final disposition of these two lawsuits in the early 1980s would insure MCI's success and change the face of American telecommunications forever. McGowan's triumph proved the virtue of patience. Victory came in 1982, but only after a decade's worth of legal struggle, during which MCI flirted with bankruptcy (the stock, which went public at 10 in 1972, fell to 7/8 in 1974; in 1975 alone the company lost \$39.3 million). As McGowan later said: "We were not really in the communications business . . . we were really in the surviving business."

Execunet, which AT&T had tried to kill, was MCI's first profitable service. In the quarter ending June 30, 1976, MCI posted earnings from operations for the first time, though the company showed a ioss due to

interest expenses. As the litigation dragged on, MCI's salespeople continued to market its services. By 1978, when a U.S. Appeals Court forced AT&T to connect the Execunet lines once and for all, there were 41,000 Execunet customers. After the monumental decision, which essentially legitimized the idea of long-distance competition, MCI and AT&T hammered out agreements through which MCI rented access to local exchanges for \$235 per line per month—a bargain that paved the way for MCI's future profits. MCI turned its first profit in the fiscal year ending March 1979, earning \$7 million on revenues of \$95.2 million.

McGowan's company began in 1980 to pitch its services aggressively to residential customers. As with Execunet, MCI residential customers had to dial up a local number, punch in an access code, and then the number. While the rates were 20 percent to 60 percent lower than AT&T's, McGowan conceded that the process was "a pain." So he continued to press for equal access—a system in which his customers could simply dial "1" and use MCI's long-distance network. MCI proved the technology could work in the summer of 1981, when Northwest Iowa Telephone Company, a 2,100-customer independent company, let MCI install equipment that provided direct access.

In June 1980 a federal jury ruled in MCI's favor in the six-year-old antitrust suit and awarded damages of \$1.8 billion, Still, McGowan was unsatisfied and sought further damages. "Let's see how deep their pockets are," he said. But his ploy didn't work: the Supreme Court reversed the award after AT&T appealed; in the separate damages-only retrial that opened in 1985 MCI received just \$300 million after seeking \$15 billion.

The Fallout

The U.S. Justice Department dealt AT&T a more powerful blow. In January 1981 *U.S. vs. AT&T* finally went to trial before Judge Harold Greene in Washington, D.C. As one of the government's star witnesses, McGowan spent four full days on the stand detailing Ma Bell's alleged predations. The newly installed antitrust chief William Baxter, a conservative Stanford law professor, pursued the seven-year-old case with zeal and drove a hard settlement bargain, On January 8, 1982, the two parties ironed out a settlement under which AT&T would divest itself of its twenty-two local operating companies, which would be transformed into seven regional Bell operating companies and continue to offer long- distance services. In addition, the newly independent local operating companies would grant equal access to competing long-distance providers.

MCI, the best-positioned and most established alternative carrier, took off in the wake of the breakup. Its revenues topped \$1 billion for the first time in 1982 when the company earned \$86 million. MCI's stock, in the tank for much of the 1970s, soared from a split-adjusted twenty-five cents a share in 1977 to \$28 in June 1983. In January 1983, with a million customers on board, MCI was enrolling 50,000 new subscribers a month. The future seemed boundless, as the \$40-billion long- distance market was growing at a 10 percent annual clip. "The only limit on our growth is our ability to build the network," McGowan said in January 1983.

Relying more on technology than staff—"We use computers, not people," McGowan liked to say—MCI's chairman regarded investment in its 15,000-mile network as the key to continued success. To truly compete with AT&T, McGowan realized that MCI needed a nationwide, state-of-the-art digital circulation system and the software to make it run efficiently. Unlike AT&T, however, MCI never made its own equipment, preferring to rely on outside suppliers. Furthermore, MCI spent little in the way of research and development. "So what if we don't get a lot of patents," McGowan would say. As a result, MCI had a lower cost structure than AT&T: in 1985, MCI's total costs per minute were estimated at twenty-five cents, compared with thirty-two cents for AT&T.

The low costs were partly a result of McGowan's no-frills ethos. When an employee innocently asked whether a new MCI office complex would have a gym, McGowan snapped: "You want exercise, go climb a microwave tower." When it came to investment in technology, however, McGowan routinely approved massive expenditures to expand MCI's network. His vision in the 1980s remained as ambitious as it had been back in the sixties. McGowan turned to Michael Milken and the high-yield bond group of Drexel Burnham Lambert in

July 1983. In one of the largest corporate bond sales in history, MCI sold \$1 billion in 9.5 percent subordinated notes. In 1984, with \$1.96 billion in annual revenues, MCI committed \$1 billion to upgrading and building its network.

The dissolution of the Bell System on January 1, 1984, brought to fruition McGowan's long-standing dream of equal access. In this new era, customers could access their choice of long-distance carriers simply by dialing "1." But by 1986 the rebel found his company in a free-for-all when MCI and dozens of new companies scrambled to sign up the 86 million U.S. telephone customers who had received ballots permitting them to choose a long-distance provider. MCI won about 13 percent of those customers.

After the breakup, the FCC ordered AT&T to cut its rates. Never to be undersold, McGowan's MCI had slashed its tariffs up to one-third. And because the FCC phased out the discount on access fees paid to local phone companies as part of the settlement, the rate MCI paid for access to local exchanges rose from \$235 per line per month to \$330. The combination of higher costs, heightened competition, and lower rates left MCI in a terrible position. In 1986 the company lost \$498 million. As if to emphasize the intense personal connection between McGowan and the state of his business, his own health declined at this time as well. The fifty-nine-year-old McGowan suffered a heart attack and received a heart transplant in April 1987. But the hard-driving executive didn't even think of retiring. "I am ready to shake things up," McGowan said.

Reverting to his old role of turnaround artist, McGowan recovered quickly and set about healing MCI. He slashed spending on MCI's largely completed network and cut the workforce by 15 percent. MCI had grown fat by investing heavily in the residential market, but McGowan refocused attention on the company's original market: businesses. "Spurred on by McGowan, MCI management improved quality and service, and pushed for more corporate customers as well," Forbes noted. In rapid succession, MCI landed major contracts from United Airlines and the Pentagon. By 1988 the company was back in the black, earning \$356 million on revenues of \$5.1 billion.

How McGowan Raised Capital

The estimated cost of McGowan's mythic network was \$100 million. A difficult amount for any company to raise, it was a seemingly impossible sum for an unknown company—one with neither products nor clients—that sought government permission to compete against the biggest company in the world.

McGowan pulled off the impossible by adopting an unusual approach. Reasoning it would be easier to raise the funds in small bites rather than one huge gulp, in 1968 he shrewdly set up seventeen shell companies based in distinct geographical territories, giving the illusion that MCI was a nationwide operator. Over the next three years, each would apply for FCC permission to build a chunk of the network. McGowan then set about capitalizing each company at about \$5 million, drawing upon his own bank account, MCI executives, and venture capital sources. In 1972, the initial fundraising complete, McGowan reorganized the company by merging the seventeen companies into one.

With MCI's financial health restored, McGowan had achieved his longtime goal: MCI was a profitable company offering nationwide longdistance service. Though married to his work well into his middle age, McGowan cut back after the heart transplant. In 1991 he reluctantly ceded the CEO's chair to MCI President Bert Roberts, a company veteran who had overseen product development dating back to Execunet.

When William McGowan suffered a fatal heart attack at the age of sixty-four in June 1992, MCI had 31,000 employees, \$10.5 billion in sales, and earnings of \$609 million. The company he had nurtured for nearly a quarter century was no longer "in the surviving business." It could now deal on equal terms with giants like British Telecom, which paid \$4.3 billion for a 20 percent stake in MCI in 1993. With about 20 percent of the nation's long-distance market, the firm McGowan built is a thriving example of the rich possibilities of competition in telecommunications.